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**Faculty of Law**  
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## **THE ROLE OF THE INDEPENDENT DIRECTOR IN MAINTAINING GOOD CORPORATE GOVERNANCE**

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Research Dissertation presented for the approval of the Senate in fulfilment of the requirements for the degree in Master of Laws (Commercial Law) in approved courses and a minor dissertation.

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## **DEDICATION**

This dissertation is dedicated to my parents, Patricia and Bernard Gona, for all their love and support throughout my schooling days.

University of Cape Town

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## **LIST OF ABBREVIATIONS**

BEE	Black Economic Empowerment
CEO	Chief Executive Officer
CFO	Chief Financial Officer
JSE	Johannesburg Securities Exchange
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
SOX	Sarbanes- Oxley Act of 2002
USA	United States of America
UK	United Kingdom



## ABSTRACT

The collapse of companies worldwide particularly the fall of Enron and WorldCom in the United States of America (USA) has led to considerable debate on the need for improved corporate governance standards in public companies. The fall of major financial institutions in the USA has also led to many corporate governance reforms through the promulgation of the Sarbanes-Oxley Act of 2000 (SOX), which regulates corporate governance at federal level and various corporate governance codes regulating corporate governance mostly at state level. SOX, amongst other things, aims to regulate the audit process and profession and increase the responsibilities of corporate boards for their failure to insure against future malfunction.<sup>1</sup> In South Africa, the need for improved corporate governance has been highlighted in the King I Report of 1994 (King I)<sup>2</sup> and the King II Report of 2002 (King II). The King II Report emphasises the need to have a good balance of executive and non-executive directors at board level. Furthermore, the King II also highlights the importance of having non-executive directors occupy certain positions on the board, such as the chairperson of the board and chair the nomination and remuneration board committees. Given the above recommendations, this dissertation focuses on the role of the independent director within corporate governance.<sup>3</sup> This dissertation seeks to ascertain the role played by the independent director in light of the numerous recommendations from the King II and other corporate governance codes. The purpose of this analysis is to highlight the importance and value the independent director brings towards maintaining good corporate governance.

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<sup>1</sup> Justin O'Brien 'The politics of symbolism: Sarbanes –Oxley in Context, Chapter 2' in Paul U. Ali and Greg N. Gregoriou. -Hoboken, N.J, International Corporate Governance after the Sarbanes Oxley Act (2006) at 9.

<sup>2</sup> In 1994 the King Report on Corporate Governance was published by the King Committee on Corporate Governance, headed by former High Court judge, Mervyn King S.C. The King Committee introduced the King I, which incorporated a Code of Corporate Practices and Conduct. The King I was the first of its kind in the country in that it aimed to promote the highest standards of corporate governance in South Africa. In 2002, the King Committee followed out by releasing the King II. Available at [http://www.cliffedekker-hofmeyr.com/files/CD\\_King2.pdf](http://www.cliffedekker-hofmeyr.com/files/CD_King2.pdf) [Accessed 29 August 2009].

<sup>3</sup> For the purposes of this dissertation, I shall refer to the non-executive director and independent non-executive director under the umbrella term independent director. The independent director referred to in this work is the director who is currently serving on the board but is not involved in the day-day activities of the company and has no material relationship with the company or its affiliates other than as a director. The independent director is also not a representative of any shareholder.

## INTRODUCTION

The role of the independent director is not clearly defined in most legislation around the globe. Hence, a company, through its Articles of Association or Memorandum of Incorporation, may attach any role it wishes the director to carry out. Most companies seem to entrust the independent director with three roles, which are the monitoring of managerial activities, strategy development, and ensuring that the company complies with the various companies' legislation.<sup>4</sup> However, Dixon et al assert that, the independent director has largely emerged, amongst other factors, due to the need to monitor managerial activities.<sup>5</sup>

In carrying out the above roles, the independent director has often been described as the cornerstone of good corporate governance in that, the director provides an unbiased, independent, varied and experienced perspective to the board.<sup>6</sup> As such, a variety of corporate governance codes have advocated for publicly listed companies to employ effective independent directors.

## AIM OF DISSERTATION

This dissertation seeks to analyse the role of the independent director in maintaining good corporate governance. The outcome of the above analysis intends to draw attention to the value the independent director brings towards maintaining good corporate governance.

## METHODOLOGY

The research for this dissertation will primarily be conducted through analysing the various corporate governance codes and legislation that regulate public listed companies. The research shall primarily focus on South Africa and other countries that share a similar corporate governance system such as Australia,

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<sup>4</sup> Rob Dixon, Keith Milton and Anne Woodhead, *An investigation into the role and effectiveness and future of non-executive directors*, (2005) Vol. 31 No.1 Journal of General Management 1 at 3.

<sup>5</sup> Ibid.

<sup>6</sup> Madhav Mehra, *Are we making a mockery of independent directors?* Available at <http://www.wcfeg.net/ht130304.htm> [Accessed 22 June 2009].

United Kingdom and the United States of America. Nonetheless, in order to draw comparisons, reference shall also be made to other jurisdictions other than those listed above.

## **STRUCTURE OF DISSERTATION**

Chapter One provides a general background to corporate governance. This is done by explaining the various concepts of corporate governance, followed by a discussion on the two main models of corporate governance, the shareholder model and stakeholder model. The purpose of discussing these two models is to put into perspective the approach to corporate governance that has been adopted in various jurisdictions. Chapter one also introduces the concept of the corporation as a separate legal entity and the effect the concept has on corporate governance. In discussing the corporation as a separate legal entity, the dissertation touches on the separation between shareholders and management (agency theory) and attempts to explain how the agency theory gave rise to the independent director. Lastly, the chapter discusses the rationale for the independent director in the corporate governance.

Chapter Two introduces the board of directors. This chapter focuses on the role of the board and the composition of the board in line with various corporate governance recommendations. The recommendations that will be discussed include, the splitting of roles between the chairperson and the chief executive officer and the need to have a majority of independent directors on the board. Having looked at the recommendations on the role and composition of the board, this chapter proceeds to discuss the duties of a director and the recent codification of some of the fiduciary duties under the new Companies Act<sup>7</sup> and the purpose of such codification. In comparison to South Africa, a brief

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<sup>7</sup> Companies Act No 71 of 2008. The new Companies Act No 71 of 2008 was assented to on 9 April 2009. The Act comes into operation on a date still to be fixed by the President by proclamation in the Gazette, which may not be earlier than one year following the date on which the President assented to this Act. The new Companies Act is available at <http://www.thedti.gov.za/ccrd/companiesact.pdf> [Accessed 12 August 2009].

discussion on the codification of director's duties in the United Kingdom will also be undertaken.<sup>8</sup>

Chapter Three introduces the concept of the independent director. This chapter examines the definition of the independent director as prescribed by legislation and corporate governance codes. The chapter begins by discussing how the current South African Companies Act<sup>9</sup> and new Companies Act<sup>10</sup> have attempted to define the independent director. The chapter also refers to how South African case law and other similar jurisdictions have differentiated between an executive director and a non-executive director.

After analysing the above legislation, chapter three undertakes a comparative analysis of how various corporate governance codes have defined the independent director and the requirements for one to qualify as an independent director under these codes. The purpose of this comparative analysis is to draw distinction as to how other jurisdictions have defined the independent director in response to the call for improved corporate governance. The codes that are analysed include the United Kingdom Combined Code, the South African King II<sup>11</sup> and the New York Stock Exchange Rules. I have chosen the above codes to highlight the distinct manner in which each code defines the independent director. Furthermore, the above codes emanate from countries that share a similar corporate governance system with that of South Africa.

After laying out the platform on what constitutes an independent director, chapter three analyses in detail the role of the independent director in corporate

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<sup>8</sup> I have chosen a comparison with the United Kingdom as it has also codified the duties of a director. Moreover, the UK also shares a similar corporate governance framework as that of South Africa.

<sup>9</sup> Act No 61 of 1973.

<sup>10</sup> Act No 71 of 2008.

<sup>11</sup> It is important to note that The King II operates under the “comply or explain” philosophy, in which a listed company is required to specify annually the King II principles with which it has not complied and explain the extent of and the reasons for any material non-compliance.

governance. This part of the dissertation adopts a similar approach as above, in that it analyses the current Companies Act, the new Companies Act and various corporate governance codes and journal articles in an attempt to ascertain how the above have defined the role of the independent director. Nonetheless, more emphasis will be placed on the corporate governance codes and journal articles, as they lay out the role of the independent director clearer than the legislation.

Chapter Four looks at the independent director in action through analysing how the director implements his role on various board committees. This chapter analyses the independent director's role on the audit committee, remuneration committee and nomination committee. This chapter also looks at whether the independent director adds value to the company and the challenges an independent director faces in carrying out his functions. This is followed by a discussion on ways to make the independent director more effective. The chapter concludes by giving a summary of the chapters covered in the dissertation before going onto chapter five, which concludes by highlighting the main arguments raised in the dissertation.

# CHAPTER 1: AN OVERVIEW OF CORPORATE GOVERNANCE

## 1.1 Defining corporate governance

The concept of corporate governance has no single accepted definition, as there are substantial differences to the definition depending on the jurisdiction being considered.<sup>12</sup> Different jurisdictions seem to attach various definitions to the concept according to the needs of the legal system and the corporate governance reforms initiated in that jurisdiction. For example, in the United Kingdom (UK) and the United States of America (USA) corporate governance is commonly defined as,

The system by which companies are directed and controlled, the primary concern being with those who supply finance to companies, the shareholders.<sup>13</sup>

Furthermore, corporate governance has also been defined as a system that is, 'concerned with the structures and processes associated with management decision-making and control within organizations.'<sup>14</sup> As such, corporate governance is primarily concerned with the relationship between the owners of the business and those who manage the business on behalf of the owners.

The corporate governance system defined above that is primarily concerned with shareholder value maximisation is commonly referred to as the shareholder model of corporate governance. This model of corporate governance sees the corporate objective as being primarily to preserve and maximise shareholder investment. Under the shareholder model, the corporation is a private rather than a public body defined by a set of relationships between the principal and agent.<sup>15</sup> In other words, the shareholder model of corporate

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<sup>12</sup> Jill Solomon, Aris Solomon *Corporate Governance and Accountability* (2007) at 12.

<sup>13</sup> Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report), Paragraph. 2.5. Available at <http://www.ecgn.org.html> [Accessed 12 March 2009].

<sup>14</sup> Wixley and Everingham, *Corporate Governance* (2002) at 1.

<sup>15</sup> Richard Smerdon *A practical guide to corporate governance* (1978) at 7.

governance concerns the relationship between the shareholders (principal) and the management (agents).

Another characteristic about the shareholder model is that the control and decision-making powers are predominately made by management. The reason for this being that, shareowners are too busy and too numerous to undertake the responsibility themselves, so they hire salaried executives to manage their affairs.<sup>16</sup>

On the other hand, there seems to be a consensus among other jurisdictions that corporate governance concerns 'supervising management performance and ensuring accountability of management to shareholders and other stakeholders.'<sup>17</sup> In comparison to the definitions found in the UK and USA, which are primarily concerned with shareholder value maximisation, the above definition is slightly wider as it encompasses the concept of accountability towards other stakeholders.

Stakeholders have increasingly become important within the corporate governance system. The reason being that, companies have become so large that their impact on society is so pervasive to an extent that they need to discharge accountability to more sectors of society than their shareholders only.<sup>18</sup> In other words, corporations need to be socially responsible for the areas in which they operate. The model of corporate governance described above is commonly referred to as the stakeholder approach to corporate governance. The stakeholder approach embraces a wider dimension through encompassing issues such as rights of workers and clients, corporate social responsibility and sustainable development.

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<sup>16</sup> Richard Smerdon, *A practical guide to corporate governance* (1978) at 7.

<sup>17</sup> Wixley and Everingham, *Corporate Governance* (2002) at 1.

<sup>18</sup> Jill Solomon, Aris Solomon *Corporate Governance and Accountability* (2007) at 23.

The King I was the first to embrace the stakeholder approach to corporate governance through 'highlighting that corporations do not operate in a vacuum'<sup>19</sup> as, 'there are links which bring together shareholders and stakeholders into an interactive situation.'<sup>20</sup> The stakeholder interactive approach seeks to align the interests of the corporation with those of society. In support of the stakeholder model, the King I also noted that companies could no longer operate in the same manner as pre-1994 given the diverse socio, political and cultural platform in the new democracy that brought about an array of new labour and employment equity laws.<sup>21</sup>

As an aside, one may argue that the stakeholder approach to corporate governance may clash with the common law duties of a director to act in the best interest of the company. This clash may emanate from the common law duty upon the directors to maximise shareholder value to the exclusion of everyone else. In response to the above, King II recommends that, companies should make decisions in the best interest of the company, however those decisions made by the company should result in the company acting responsibly and responsively towards its stakeholders.<sup>22</sup>

The stakeholder approach has received great popularity in Continental Europe. In this part of the world, 'the central preoccupation of corporate governance is the rights of the community.'<sup>23</sup> The stakeholder approach as applied in Continental Europe encourages corporations to strike a balance between their economic goals and the social goals they owe to the community. Thus, in Continental Europe, a corporation's social responsibility, accountability,

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<sup>19</sup> King M *The Corporate Citizen* (2006) at 8.

<sup>20</sup> King M *The Corporate Citizen* (2006) at 8.

<sup>21</sup> The stakeholder approach allows the companies to consider the view of its employees, and the larger society in which the company operates.

<sup>22</sup> Tshepo Mongalo *Convergence of Traditional Corporate Governance and Modern Corporate Governance Reforms: Is the King 2 déjà vu for Boards of Directors or is it a set of new principles?* *Obiter* (2004) 79 at 79.

<sup>23</sup> Salacuse, Jeswald *Corporate Governance in the New Century* (2004), *The Company Lawyer* Vol.25, 69-83 at 72.



and corporate objectives involve advancing the interests of stakeholders such as the employees and the wider community, beyond the traditional category of shareholders. For example, some corporations have employee representatives on supervisory boards.<sup>24</sup> To some extent, the supervisory board is used as a vehicle to enforce employee rights.

## 1.2 Emergence of corporate governance

It is interesting to note that the practice of corporate governance is not a new concept as it has been 'practiced for as long as there have been corporate entities.'<sup>25</sup> Corporate governance has been developing over a long period of time to meet the needs of the corporations. It has been long since established that corporate entities need direction in order to allow them to function whilst maintaining a balance of power between the owners of the business (shareholders) and those who run the business (management).<sup>26</sup> Mongalo asserts that,

Early legislation such as the South African Companies Act of 1924, the company's articles of association and the common law have always regulated principles of corporate governance.<sup>27</sup>

The author also notes that:

It is clear that corporate governance issues such as fiduciary duties of directors, requirements for special resolutions, the role of shareholders and company meetings have always been provided for in terms of both common law and companies' legislation.<sup>28</sup>

In reference to the above, Mongalo cites an example of a shareholder's right to sue a director for breach of a fiduciary duty through a derivative action

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<sup>24</sup> For instance in Germany, depending on the size of the company or industry, employees have the right to name board representatives. Available at

<http://www.eurofound.europa.eu/eiro/1998/09/study/tn9809201s.htm> [Accessed 20 August 2009].

<sup>25</sup> Tshepo Mongalo, *Convergence of Traditional Corporate Governance and Modern Corporate Governance Reforms: Is the King 2 déjà vu for Boards of Directors or is it a set of new principles?* Obiter 2004 79 at 79.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

<sup>28</sup> Ibid at 80.

provided for by s 266 of the current South African Companies Act.<sup>29</sup> A similar provision, though wider in application than the current Companies Act, is also present under the new Companies Act.<sup>30</sup>

Furthermore, under various companies' legislation, the shareholders through a special resolution have the power to appoint and remove directors. This enables shareholders to influence the board appointment process, which in turn means that if a certain director or directors are not performing to the benefit of the shareholders that director may be removed.<sup>31</sup>

Mongalo refers to the above-mentioned type of corporate governance that is provided for in terms of the common law, company legislation and Articles of Association as the traditional or conventional type of corporate governance. The conventional type of governance has legal backing and aggrieved parties may seek recourse in a court of law.

On the other hand, the corporate world has also been at the forefront of promoting and establishing the various codes of good corporate governance in response to corporate governance failures or the need to improve corporate governance standards. For instance, the King I Report of South Africa, which was introduced in 1994, 'was instrumental in raising awareness of what constitutes good governance, both in private and public sectors.'<sup>32</sup> Following the King I Report, the King II Report reviewed the developments that had taken place in the South African economy and in the global markets since 1994.<sup>33</sup> Currently,

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<sup>29</sup> Act No 61 of 1973.

<sup>30</sup> Section 165(2) of Companies Act No 71 of 2008. This above section allows shareholders and other parties mentioned in s165 (2) to take necessary steps to protect the legal interests of the company.

<sup>31</sup> Section 210 of the Companies Act 61 of 1973 and section 68 of the Companies Act No 71 of 2008. respectively, provide for the appointment of directors.

<sup>32</sup> Philip Armstrong, Nick Segal and Ben Davis, *Corporate Governance in South Africa* in C.A Mallin *Handbook on International Corporate Governance: Country Analysis* at 214.

<sup>33</sup> Ibid at 215.

there is the Draft King III Report<sup>34</sup>, which emerged because of the new Companies Act<sup>35</sup> and changes in international governance trends.

This new system of corporate governance is known as the 'self regulating regime of corporate governance.'<sup>36</sup> Although the code-based system of corporate governance lacks legal enforcement, it is underpinned by the philosophy of 'comply or explain.'<sup>37</sup> That is to say, although the corporate codes are not legally enforceable, companies are required to explain their extent of non-compliance.<sup>38</sup> Moreover, in South Africa, certain King II recommendations have been integrated into the Johannesburg Stock Exchange (JSE Limited) listing requirements and are thus binding on Companies listed on this securities exchange.<sup>39</sup> Under the JSE listing requirements, listed companies have to comply or explain the extent to which they have not complied with the guidelines.

### 1.3 The purpose of Corporate Governance

The essential purpose of corporate governance is to protect the external providers of capital (shareholders). Without meaningful protection for external capital providers, those who control the corporation can use their position for inappropriate economic benefits, often at the expense of the long-term performance and value of the enterprise.<sup>40</sup> As such, all the other purposes of corporate governance essentially flow from the need to protect the external providers of capital. For instance, where good corporate governance is practised, it helps to prevent corporate scandals, fraud and potential civil and criminal

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<sup>34</sup> Available at <http://www.iodsa.co.za/downloads/reports/King%20Report%2025%20Feb%202009.pdf> [Accessed 19 June 2009]. The Draft King III was released for comment in February 2009.

<sup>35</sup> Companies Act No 71 of 2008.

<sup>36</sup> Tshepo Mongalo, *Convergence of Traditional Corporate Governance and Modern Corporate Governance Reforms: Is the King 2 déjà vu for Boards of Directors or is it a set of new principles?* *Obiter* 2004 79-90 at 81.

<sup>37</sup> *Ibid* at 81.

<sup>38</sup> The comply or explain philosophy differs significantly from the statutory regime which is underpinned by the 'comply or else' philosophy. That is to say, there are legal sanctions for non-compliance.

<sup>39</sup> Kathleen van der Linde Title, *The personal liability of directors for corporate fault- An Exploration*, (2008) Vol. 20 No 4 South African Mercantile Law Journal at 441.

<sup>40</sup> Corporate Governance: A Framework for Implementation. Available at <http://www.systemiclogic.net/artifacts/PUB/governance/gcgfb booklet.pdf> at 4 [Accessed on 12 June 2009].

liability of the organization. Should there be any corporate fraud or loss the shareholders suffer financially, hence the need for good corporate governance practices to minimise losses to the shareholders.<sup>41</sup>

Practising good corporate governance is also good for business as it enhances the reputation of the corporation through making the business more attractive to customers, investors and suppliers.<sup>42</sup> Investors are likely to invest in a company with a good corporate governance reputation than in one without good governance practices.<sup>43</sup> A recent survey by management consultants McKinsey & Co showed that,

Investors are ready to pay a substantial premium for share in a company with good corporate governance, especially in non-Organization for Economic Cooperation and Development economies.<sup>44</sup>

A good system of corporate governance also influences a country's capacity to attract foreign capital. International investment not only provides corporations with expanding sources of resources, but also encourages the continuous amalgamation of sound corporate governance practices, which may assist the corporations to gain the trust of investors, lessen their capital costs and induce more stable financial sources.<sup>45</sup>

The Organisation for Economic Co-operation and Development (OECD) principles on Corporate Governance also reflect that:

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<sup>41</sup> The above risks may be prevented through the monitoring role played by independent directors. Since the independent director acts as a watchdog, that director is tasked with ensuring that the company is following the relevant laws and corporate guidelines. If companies adhere to the corporate guidelines, there is a possibility that corporate fraud may be reduced, thus creating more value for the shareholders.

<sup>42</sup> Frederick D. Lipman and L Keith Lipman *Corporate Governance Best Practices: Strategies for Public, Private, and Not-for-Profit Organisations* (2006) at 3.

<sup>43</sup> Salacuse, Jeswald *Corporate Governance in the New Century* (2004) ,The Company Lawyer at 70

<sup>44</sup> Why Good Corporate Governance is Crucial to Development available at <http://www.oecd.org.html> [Accessed 12 March 2009].

<sup>45</sup> Melinda Vaughn and Lori Verstegen Ryan, 'Corporate Governance in South Africa: a bellwether for the continent?' *Corporate Governance: An International Review* (September 2006) Vol.14 No.5 available at <http://www3.interscience.wiley.com/cgi-bin/fulltext/118730475/PDFSTART-> [Accessed 12 March 2009]

Good corporate governance means more efficient utilisation of resources, better access to capital, better and higher quality employment opportunities, and a better chance of developing in a sustained way efficient domestic or regional capital markets. Corporate governance is also important for the effectiveness of public institutions; better-governed companies are less likely to bribe regulators and judges.<sup>46</sup>

From the above brief discussion, it is evident that good corporate governance is integral to investor financing and sustainability of a business. As noted earlier, research has also shown that investors are willing to invest in a corporation with good corporate practices as compared to a corporation with bad corporate governance practices. Hence, following good corporate governance recommendations such as increasing the number of independent directors on the board is a signal of good corporate governance, which may persuade investors to invest in the company.

#### **1.4 The Corporation as a separate legal entity**

In *Salomon v Salomon and Co Ltd*<sup>47</sup>, the court noted that, 'a company has a legal existence with rights and liabilities of its own, whatever may have been the ideas and schemes of those who brought it into existence.' In other words, a company is a separate legal entity from those who own it. As such, when a wrong is committed against a company, the company sues as the plaintiff in the proceedings and not the members. Similarly, in *Macaura v Northern Assurance Co Ltd* the court stated that,

The property of a company belongs to it and not to its members. Neither a member nor a creditor of a company (unless a secured creditor) has an insurable interest in the assets of the company.<sup>48</sup>

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<sup>46</sup> Available at <http://www.oecd.html> [Accessed 12 March 2009].

<sup>47</sup> (1897) AC 22.

<sup>48</sup> (1925) AC 619 (H.L)

As corporations grew and developed over time, those who owned the corporation had to employ management who possessed knowledgeable skills and expertise to run the affairs of the corporation. Management was delegated the power to make the day-to-day decisions on running the corporation on behalf of its shareholders. This delegation of power created a divorce of ownership and control<sup>49</sup>, which in turn led to the agency problem. Under the agency problem, the managers of the company are defined as agents and the shareholder as the principal.<sup>50</sup> In essence, this means that, the principal of the company (owner) delegates the daily decision making to the agents who are directors of the company.<sup>51</sup>

The fundamental challenge that arises from the divorce in ownership and control is that the agents may not always act in the best interest of the shareholders. For instance, 'the managers may act in their own interests at the expense of the shareholders, thereby reducing the expected gains, not only for the shareholders but for society as a whole.'<sup>52</sup> Management may also tend to focus on projects and company investments that provide short terms profits, for instance where the manager's pay is related to this variable, rather than maximising long-term shareholder wealth through investment in projects that are long term in nature. Due to the separation of ownership from control, Mongalo also asserts that:

Management develops the tendency to act in a self-serving manner because they only receive a tiny fraction of profits generated by their activities since they rarely own a substantial number of shares in such companies. They thus act in their own interest rather than endeavour to maximize shareholder value. Moreover, to the extent that top executives pursue their own agenda rather than seeking to improve the profitability of the company, they impose what can be referred to as 'agency costs' on investors.<sup>53</sup>

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<sup>49</sup> Jill Solomon *Corporate Governance and Accountability* (2000) at 17.

<sup>50</sup> Ibid.

<sup>51</sup> Ibid.

<sup>52</sup> J.E Parkinson, *Corporate Power and Responsibility* (1993) at 52.

<sup>53</sup> Tshepo Mongalo, 'The Emergence of Corporate Governance as a Fundamental Research Topic in South

Overcoming the separation of ownership and control is problematic for a number of reasons. Firstly, a growing number of shareholders focus little on their investments so long as there are satisfactory dividends from their investments. This shareholder passiveness has allowed directors and managers to engage in activities that are detrimental to the company. Secondly, shareholders lack the necessary time, money, and experience to make full use of their rights, and in many cases shareholders are too numerous or too widely dispersed to be able to organize themselves effectively monitor management.<sup>54</sup> Finally, due to a dispersed share ownership structure, no single shareholder owns enough stock to affect corporate decision-making resulting in the firm effectively been controlled by its managers.

The question that now arises, despite the challenges associated with the overcoming the divorce in ownership, is how are shareholders to exercise control over management? Various governance mechanisms have been advocated for to control managerial power. These include, monitoring by financial institutions, prudent market competition, developing an effective and independent board of directors, markets for corporate control, concentrated holdings and executive compensation.<sup>55</sup> Solomon also asserts that, in order to control management there is need for an alignment of interests between the managers and the shareholders. To achieve this alignment, shareholders 'as owners of the company have the right to influence the manner in which a company is run through voting on director appointments at the Annual General Meeting.'<sup>56</sup> The Annual General Meeting is a good platform to appoint directors who share the same interests with the shareholders. In the same vein, the Annual General

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*Africa* (2003) Vol. 120 Issue 1 South African Law Journal 173-191 at 178

<sup>54</sup> Company Law Amendment Committee, CMD 6059 (1945) paragraph 7e.

<sup>55</sup> Livia Bonazzi and Sardar M.N. Islam, 'Agency theory and corporate governance: A study of the effectiveness of board in their monitoring of the CEO' (2007) Vol. 2 No. 1, *Journal of Modelling in Management* 7 at 7-8. Available at <http://www.emeraldinsight.com/1746-5664.html> [Accessed 12 June 2009].

<sup>56</sup> Jill Solomon, *Corporate Governance and Accountability* (2000) at 19.

Meeting may also be used to elect independent directors to assist in the alignment of shareholder and managerial interests.

In order to facilitate the alignment of managerial and shareholder interests, the King II also recommends that corporate boards be comprised of a majority of independent non-executive directors who are independent of management so as to be able to protect the interests of shareowners.<sup>57</sup> Similarly, the UK Combined Code on Corporate Governance recommends that the board should be composed of a good balance of non-executive directors, preferably independent non-executive directors, to avoid any individuals or group of individuals from dominating the board processes.<sup>58</sup> The Australian Stock Exchange Principles also recommend that the majority of the board be composed of independent directors.<sup>59</sup> Given the various recommendations on how the independent director may assist in the alignment of shareholder and managerial interests, it is necessary to discuss in detail the rationale of the independent director on corporate boards.

### **1.5 Why the Independent Director?**

As stated earlier, the need for the independent director emerged because of the challenges associated with the agency problem i.e. the separation of ownership and control. These challenges compelled shareholders to appoint independent directors to act as a third eye to watch over the activities of management and ensure that management acts in the best interests of the shareholders.

In carrying out this monitoring role<sup>60</sup>, an independent director assists in reducing conflicts of interest between the shareholders and the company

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<sup>57</sup> King II Report paragraph 2.2.1 at 24. Available at <http://www.idosa.co.za> [Accessed 15 June 2009].

<sup>58</sup> The United Kingdom Combined Code on Corporate Governance Paragraph A3

<sup>59</sup> Australian Principles of Good Corporate Governance and Best Practice Recommendations (Principles), Principles Box 2.1 at 20. Available at <http://www.shareholder.com/shared/dynamicdoc/ASX/364/ASXRecommendations.pdf> [Accessed 25 June 2009].

<sup>60</sup> The monitoring role of the independent director will be discussed in detail under chapter 3.



management through bringing an independent voice to the boardroom.<sup>61</sup> Langley J in *Equitable Life Assurance Society v Bowley*<sup>62</sup> also noted that, a company might reasonably look to a non-executive director's independence of judgement in the supervision of the executive management and in conflict resolution. Furthermore, the Cadbury Committee noted that due to their independence from executive responsibility, independent directors are able to assist in reviewing the performance of board executives and take the lead where potential conflicts of interest arise. For instance, independent non-executive directors are well placed to resolve conflicts emanating from takeovers, boardroom succession, or directors' pay, as their interests are less directly affected.<sup>63</sup> In the same vein, the King II also recommends that South African boards increase their proportion of truly independent directors, as independent directors are more likely than inside directors to be free from conflicts of interest and better able to protect shareholder interests.<sup>64</sup>

The independent director also assists in protecting small shareholders against large shareholders, who use their voting power to select directors and managers who will do their bidding at the expense of the powerless minority.<sup>65</sup> Although such independent directors face the risk of been ostracised by the large shareholders or executive directors, those particular independent directors may 'provide a degree of protection to minority shareholders by publicising, or threatening to publicise, majority shareholder's abuses of which the independent director became aware.'<sup>66</sup>

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<sup>61</sup> Jill Solomon *Corporate Governance and Accountability* (2000) at 69.

<sup>62</sup> [2003] EWHC 2263, at [41] case cited in *Len Sealy and Sarah Worthington Cases and materials in Company Law* (2007) at 245

<sup>63</sup> Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report), Para. 2.5, available at <http://www.ecgn.org.html> [Accessed 10 April 2009].

<sup>64</sup> Institute of Directors in Southern Africa *Executive Summary of the King II of 2002* at 22-23. Available at <http://www.iodsa.co.za>

<sup>65</sup> Donald C. Clarke 'Three concepts of the Independent Director' (2007) Vol. 32 No 2 Delaware Journal of Corporate Law 73 at 80.

<sup>66</sup> Ibid.

However, concerning the above, Clarke asserts that,

Given corporate law is generally designed to give the largest shareholders the largest voice in choosing directors, it is difficult to see how directors representing minority shareholders could be elected to the board in the first place unless the basic principles of director selection were changed.<sup>67</sup>

Clarke also asserts that, cumulative voting is a possible solution to protect minority shareholders, but this system will elect directors representing at best a concentrated minority, not a dispersed minority, and even such directors will be in a minority on the board and can always be outvoted.<sup>68</sup>

The independent director is also important in that the director assists in certifying that the company has complied with the required standards. For instance, in terms of the new Companies Act<sup>69</sup> the audit committee, which is mostly composed of independent directors, is tasked with preparing reports to be submitted to the board as part of the annual financial statements.<sup>70</sup> The report submitted by the audit committee must amongst other issues comment on the financial statements, the accounting practices and the internal financial control of the company.<sup>71</sup> The independent director as well assists in certifying that the annual report is accurate, or that the balance sheets have been prepared in accordance with the proper accounting standards<sup>72</sup> through giving an independent view as an outsider.

In addition, an independent director is seen as an important guarantee of integrity and accountability of companies. It is assumed that the interests of those who invest in the company will be safe guarded by the presence of independent directors who can exercise independent judgement. In addition to the above,

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<sup>67</sup> Ibid 73.

<sup>68</sup> Ibid

<sup>69</sup> Act No 71 of 2008.

<sup>70</sup> Section 94 (7) (f) of the Companies Act No 71 of 2008.

<sup>71</sup> Ibid

<sup>72</sup> Donald C. Clarke, Three concepts of the Independent Director, (2007) Vol. 32, No 1 Delaware Journal of Corporate Law, 73 at 83

independent directors often see risks and opportunities overlooked by the company executives who are typically immersed in the day-to-day running of the business.<sup>73</sup>

Emerging from what has been discussed above, we note that the main reasons for having independent directors are that they aid in conflict resolution and bring an independent view to matters before the board. Most importantly, we observe that independent directors primarily act as watchdogs over management. Having discussed the rationale for the independent director, the next chapter discusses the board of directors and the role of the board in corporate governance.

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<sup>73</sup> Christopher Pass, *Corporate Governance and the role of non-executive directors in large UK companies: an empirical study*. (2004) Vol. 4. No2 Corporate Governance 52 at 55. Available at <http://www.emerald-library.com> [Accessed 12 April 2009].

## CHAPTER 2: THE BOARD OF DIRECTORS

### 2.1 The Board of Directors

The composition of the board of directors is one aspect of corporate governance that has brought about a lot of debate. Ideally, for a board to work effectively, the interaction that takes place at board meetings should ensure rational, objective and independent decision making in the best interest of the enterprise.<sup>74</sup> In other words, an essential ingredient for an effective board is the ability to make decisions in an environment that facilitates an independent decision-making process.

A number of corporate governance guidelines have suggested recommendations that attempt to make a board more independent and effective. One such recommendation, which is discussed below, is that, 'the board should comprise a balance of executive and non-executive directors, preferably with a majority of non-executive directors.'<sup>75</sup>

### 2.2 Composition of the board

South Africa has largely adopted a unitary board structure, which brings together executive and non-executive board members. The King II recommends that the board be composed of a good balance of executive and non-executive directors, with preferably a majority of non-executive directors, whom are independent of management.<sup>76</sup> The UK corporate governance system, which also has a unitary board structure, provides that the board should include a balance of executive and non-executive directors and in particular independent non-executive directors such that no individual or small group of individuals can dominate the decision-making process of the board.<sup>77</sup> The UK Combined Code further provides

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<sup>74</sup> Wixley and Everingham, *Corporate Governance* (2002) at 19.

<sup>75</sup> King II, paragraph 2.2.1. Available at <http://www.iodsa.co.za> [Accessed 19 June 2009].

<sup>76</sup> Ibid.

<sup>77</sup> The United Kingdom's Combined Code provision A.3. Available at <http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf> [Assessed 14 June 2009].

that, except for smaller companies, at least half the board, excluding the chairperson, should comprise non-executive directors determined by the board to be independent. The UK Combined Code also states that a smaller company should have at least two non-executive directors.<sup>78</sup>

The Cadbury Report of the United Kingdom also recommended that the board should include a minimum of three non-executive directors who are able to influence board decision. The non-executive directors should be able to provide an independent view on the corporate strategy, performance, resources, appointments and standards of conduct. To ensure independence of the non-executive directors the report also recommended that the fees payable to non-executives should take into account the value of contribution made by the non-executive directors. In addition, the fees payable to these directors should not compromise their independence.<sup>79</sup> In order to ensure the independence of non-executive directors, the report also encourages the directors not to take part in share option schemes as this could compromise their independence.<sup>80</sup>

Undoubtedly, should non-executives take part in share option schemes, the directors may fall into the same trap as the executives of maintaining a high share price, as this has a direct bearing on their remuneration, instead of focusing on the long-term goal of developing the company and creating value for present and future shareholders.<sup>81</sup> The above practise is referred to as short termism. Short termism is a 'tendency to foreshorten the time horizon applied to investment decisions, or raise the discount rate above that appropriate to the firm's opportunity cost of capital.'<sup>82</sup>

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<sup>78</sup> The United Kingdom's Combined Code provision A.3.2. Available at <http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf> [Assessed 14 June 2009].

<sup>79</sup> Jill Solomon, *Corporate Governance and Accountability* (2000) at 69.

<sup>80</sup> Ibid at 70.

<sup>81</sup> The United Kingdom corporate governance system commonly refers the preoccupation by executives of maintaining a high share price as short-termism.

<sup>82</sup> Note 78 at 17.

As an aside, the adoption of the unitary board system has been described as a major drawback of the King II.<sup>83</sup> The reason being that, the King II recommends the unitary board system, 'but equally tasks boards with meeting demanding stakeholder requirements'. The Continental European stakeholder model of corporate governance more easily accommodates these stakeholder requirements, such as HIV sensitivity and the promotion of Black Economic Empowerment (BEE).<sup>84</sup> As shall be discussed below, under the European stakeholder model (two tier board system), 'business and organisational issues are the remit of the executive board and broader economic, stakeholder and societal concerns fall under the umbrella of the supervisory board'.<sup>85</sup>

The unitary board system differs significantly from the European Continental system that has a two-tier board system, which separates the supervisory function and the management function into different bodies. The two-tier system characteristically has a supervisory board composed of non-executive board members and a management board composed entirely of executives.<sup>86</sup> For example, the supervisory board could be comprised of '50 per cent of shareholder elected representatives and 50 per cent of individuals elected by the employees'.<sup>87</sup>

The CEO heads the management board, which focuses on operational issues of major importance. The supervisory board on the other hand deals with strategic decisions, oversees the management board and does not take part in daily corporate decision-making. The supervisory board is an important internal 'control mechanism for shareholders as it has the authority to nominate, reward

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<sup>83</sup> Andrew Kakabadse and Nada Korac-Kakabadse, *Corporate governance in South Africa: Evaluation of the King II Report (Draft)*, *Journal of Change Management*, (2002) Vol. 2, Issue 4, 305–316 at 312.

<sup>84</sup> Ibid.

<sup>85</sup> Ibid.

<sup>86</sup> Using the OECD Principles of Corporate Governance: A Boardroom perspective, at 58. Available at <http://www.oecd.org/html> [Accessed 31<sup>st</sup> March 2009].

<sup>87</sup> Tshepo Mongalo, *Corporate Law & Corporate Governance: A Global Picture of Business Undertakings in South Africa*, (2003) at 156.

and remove executive directors from office and to ratify audit reports, capital investments and other key corporate decisions.<sup>88</sup> This type of board structure has gained popularity in Continental Europe, as Continental Europe has often advocated a stakeholder approach to corporate governance as it provides for greater stakeholder inclusiveness than unitary boards.

### 2.2.1 Board Committees

Companies set up board committees to assist the board to carry out its functions. In South Africa, the current Companies Act<sup>89</sup> and new Companies Act<sup>90</sup> make it mandatory for publicly listed companies to have an audit committee. The new Companies Act, in addition to the mandatory requirement of an audit committee, allows companies to form any number of committees of directors to meet the company's demands.<sup>91</sup> The King II also recommends the formation of board committees to which the board may delegate its functions without abdicating its own duties. However, the delegation of board functions to board committees in no way satisfies or constitutes compliance by a director to the duties owed to the company.<sup>92</sup>

Under the King II, each board should have an 'audit and remuneration committee and that industry and company specific issues should dictate the requirement for other committees.'<sup>93</sup> Therefore, depending on the size and complexity of the company, more board committees may be required. The King II also recommends that an independent non-executive director chair the various board committees.<sup>94</sup> The above recommendation ensures that the interests of the

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<sup>88</sup> Bezemer, Pieter-Jan Maassen, Gregory F. Van den Bosch, Frans A. J. *Corporate Governance: An International Review*; (2007), Vol. 15 Issue 6 at 1116. Available at <http://web.ebscohost.com/ehost.html> [Accessed on 30 March 2009].

<sup>89</sup> Section 269A of Act No 61 of 1973.

<sup>90</sup> Section 94 of the Companies Act No 71 of 2008.

<sup>91</sup> Section 72 (1) of the Companies Act No 71 of 2008.

<sup>92</sup> Section 72 (3) of the Companies Act No 71 of 2008.

<sup>93</sup> King II of 2002 paragraph 2.7.5 available at <http://www.iodsa.co.za.html> [Accessed 30 March 2009].

<sup>94</sup> Both reports also recommend that the committees consist of majority independent directors.

shareholders and other stakeholders are properly considered.<sup>95</sup> Furthermore, it limits the executive involvement in issues such as remuneration and nomination of directors.

### 2.2.2 Appointment of Directors

In South Africa, shareholders appoint directors in terms of the Companies Act.<sup>96</sup> The King II recommends that procedures for appointment should be formal, transparent, and be assisted where appropriate by a nomination committee constituted of non-executive directors only.<sup>97</sup> Similarly, the UK Combined Code provides for a formal, rigorous and transparent procedure for the appointment of new directors to the board.<sup>98</sup> The UK Combined Code further provides that, appointments to the board should be made on merit and based on an objective criterion. The UK Combined Code importantly provides that, 'care should be taken to ensure that appointees have enough time available to devote to the job.'<sup>99</sup> The above provision aims to limit directors from taking on numerous appointments, which may lead to inadequate attention being given to the boards they currently serve.

When selecting individuals for appointment to the board, it is imperative that the nomination committee pick the right individuals to enable the board to function effectively. Therefore, the nomination committee should not only nominate directors for their ability to challenge management. Rather, for example, an independent director should be appointed for his business and personal ability to add symbolic lustre to a company's board.<sup>100</sup> That is to say,

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<sup>95</sup> Ramani Naidoo, *Corporate Governance An essential guide for South Africa Companies* (2002) at 55.

<sup>96</sup> Section 210 of the Companies Act No 61 of 1973 and section 68 of the Companies Act No 71 of 2008 respectively provide for the appointment of directors.

<sup>97</sup> Institute of Directors in Southern Africa *Executive Summary of the King II of 2002* paragraph 2.2.2 available at <http://www.iodsa.co.za.html> [Accessed 30 March 2009].

<sup>98</sup> The UK Combined Code, paragraph A.4. Available at <http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf> [Assessed 14 June 2009]

<sup>99</sup> Ibid.

<sup>100</sup> Note 95 at 55.



when selecting board members, companies must have a list of core competencies (skills, knowledge and experience) they require from the director. Equally important are the person's attitude, values, sensitivity to the corporation's issues, ability to work as a team member, accessibility and willingness to devote time to the corporation's needs.<sup>101</sup> Board members should also be people of integrity who are willing and able to make the right decisions. In other words, board members should be able to make independent decisions without undue influence from any shareholder or from anyone outside the board. One of the failures of Enron Corporation was that, the board of directors was composed of directors who were of poor moral character and willing to conduct fraudulent activity.<sup>102</sup> This led to the non-executive directors in Enron's audit committee failing to police their auditors due to serious conflicts of interest involving members of the audit committee.<sup>103</sup>

### **2.3 Chairperson and Chief Executive Officer**

Numerous corporate governance guidelines recommend the separation of the position of chairperson and CEO. The fundamental reason for the separation is to demonstrate the independent role of the chairperson. Hence, the chairperson should ideally be an independent director. The chairperson's role should not be one of dominating the board, but one of seeking to achieve maximum participation from the board members through providing the board with leadership.<sup>104</sup> The Chairperson of the board plays a central role in ensuring the proper functioning of the board as,

He acts as an important channel of communication between the board and management of the company, it is his duty to ensure that the board is properly briefed on the issues arising at board

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<sup>101</sup> Vijay Padaki and Manjulika Vaz, *Management Development in Non-Profit Organisations: A programme for Governing Boards*, (2005) at 159.

<sup>102</sup> Solomon and Solomon, *Corporate Governance and Accountability* 2nd ed (2007) at 41.

<sup>103</sup> Ibid. This point shall be elaborated further in the chapter that looks at the role of the independent director on board committees.

<sup>104</sup> Tom Wixley and Geoff Everingham, *Corporate Governance* 2<sup>nd</sup> ed (2005) at 48.

meetings so that directors are able to ask the right questions and to make informed decision.<sup>105</sup>

The chairperson has more of a demanding role than other independent directors do, as the company requires the chairperson have a close understanding of operational and strategic issues in order to run the board effectively.<sup>106</sup> Hence, the company often promotes the chairperson is from within the ranks (i.e. the CEO becomes the chairperson) due to his in-depth knowledge of the operations of the company. On the other hand, the CEO is responsible for the strategic operational performance of the enterprise. That is to say, the CEO is responsible for the day-to-day management of the company.

Another rationale for separating the two roles is to prevent a CEO with a domineering personality from imposing his or her will on the board by assuming the role of the chairperson as well. For instance, some board members may be reluctant to support strategies and policies that are contrary to the interests of corporate management for fear of incurring the disapproval of their leader.<sup>107</sup> The separation also aims to ensure a balance of power and authority, such that no one individual has unfettered powers of decision-making.<sup>108</sup> Moreover, the separation attempts to reduce the agency problems through fostering more independent decision-making.<sup>109</sup> Wang & Dewhirst also assert that separating the positions of the CEO and chairperson disperses power and authority, thus

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<sup>105</sup> Ramani Naidoo *Corporate governance: An Essential Guide for South African Companies* (2002) at 62.

<sup>106</sup> Kevin Keasey and Robert Hudson, *Non-executive directors and the Higgs Consultation Paper*, 'Review of the role and effectiveness of non-executive directors.' (2002) Vol. 10 No 4 Journal of Financial Regulation and Compliance 361 at 362. Available at <http://www.emeraldinsight.com>. [Accessed 5 April 2009].

<sup>107</sup> Carol-Anne Ho, S. Mitchell Williams, International comparative analysis of the association between board structure and the efficiency of value added by a firm from its physical capital and intellectual capital resources, (2003) Vol. 38 The International Journal of Accounting 465–491 at 474.

<sup>108</sup> Institute of Directors in Southern Africa *Executive Summary of the King II of 2002* at paragraph 2.3.1 available at <http://www.iodsa.co.za> [Accessed 14 June 2009].

<sup>109</sup> Donaldson, L and Davis J.H (1994) 'Boards and company performance- Research challenges the conventional wisdom' Corporate Governance: An International Review. 2 (3) July 151-160. Quoted from Jill Solomon, Corporate Governance and Accountability (2002) at 68.

enhancing the board's ability to implement efficiently decisions addressing the welfare of a more diverse set of stakeholders.<sup>110</sup>

Separating the two roles also helps to reduce possible conflict of interest. For example, under the CEO duality system the CEO/chairperson is responsible for running the board meetings, setting agendas and overseeing the processes of hiring, firing and compensating top management, including the CEO. The CEO/chairperson is also in a position of self-evaluation, of which it is unreasonable to think that the CEO/chairperson can and will make such an evaluation objectively.<sup>111</sup>

Furthermore, 'a company with good corporate governance structure such as split roles... is likely to display more effective monitoring of management'<sup>112</sup> as compared to a company without the split of roles. The above may be attributed to the ability of the chairperson's position to render an outsider's perspective on the performance of management. In complementing the King II, the Johannesburg Securities Exchange (JSE) listing requirements make the separation of the roles of the chairperson and the CEO mandatory for companies listed with the JSE. However, where the two roles are combined this needs to be justified each year in the company's annual report.<sup>113</sup>

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<sup>110</sup> Wang, J., & Dewhirst, H. D, Boards of directors and stakeholder orientation. . (1992). Vol. 11 No 2 Journal of Business Ethics 115-121. Quoted in Carol-Anne Ho, S. Mitchell Williams, International comparative analysis of the association between board structure and the efficiency of value added by a firm from its physical capital and intellectual capital resources, (2003) Vol. 38 The International Journal of Accounting 465-491 at 475.

<sup>111</sup> Steven T. Petra, *Do outside independent directors strengthen corporate boards?* (2005) Vol. 5 Issue No 1 Corporate Governance at 57.

<sup>112</sup> Tshepo Mongalo, *Convergence of Traditional Corporate Governance and Modern Corporate Governance Reforms: Is the King 2 déjà vu for Boards of Directors or is it a set of new principles?* Obiter 2004 at 68

<sup>113</sup> Institute of Directors in Southern Africa *Executive Summary of the King II of 2002* paragraphs 2.3.4 available at <http://www.iodsa.co.za/html> [Accessed 30 March 2009].

## 2.4 The role of the board of directors

The statutory role of the board is to manage the business affairs of the company and perform any acts that are provided for by the Memorandum of Incorporation and company legislation.<sup>114</sup> In other words, apart from issues requiring shareholder approval, the board is the ultimate corporate authority. As such, the board is generally responsible for strategic planning which aims to foster the company's vision. The King II describes the board as the focal point of the corporate governance system and is ultimately accountable and responsible for the performance and affairs of the company.<sup>115</sup> The King II summarises the role of the board as follows:

The board should be able to exercise objective judgment on the corporate affairs of the company, independent of management but with sufficient management information to enable a proper and objective assessment to be made by the directors collectively. The board should guide and set the pace of the company's current operations and further development and in so doing should regularly review the present and future strengths, weaknesses and opportunities of, and threats to the company.<sup>116</sup>

In pursuant to the above, the OECD principles on corporate governance also recommend that the board exercise an objective and independent judgement in carrying out the activities of the company.<sup>117</sup> Here, the independent director is essential as the director brings a different voice and viewpoint from the executive directors who transact with the company on a regular basis. In carrying out its corporate governance role, the board ultimately has four functions, which are discussed below.

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<sup>114</sup> Section 66 (1) of the Companies Act No 71 of 2008.

<sup>115</sup> Institute of Directors in Southern Africa *Executive Summary of the King II of 2002*. Available at <http://www.iodsa.co.za> [Accessed 14 June 2009].

<sup>116</sup> King II at paragraph 15.

<sup>117</sup> OECD, *Principles on Corporate Governance* at 58. Available at <http://www.oecd.org/html> [Accessed 30 March 2009].

### 2.4.1 Management, Board Selection and Succession

Apart from selecting the CEO and the principal management, the board is also tasked with replacing the CEO and management that have failed to discharge their responsibilities whether for business performance or unlawful and ethical behaviour. As such, the board is responsible for adopting control mechanisms to ensure that management's behaviour and actions are consistent with the interests of the owners. These important control mechanisms include, as noted above, the selection, evaluation and if necessary removal of a poorly performing CEO and top management. It also includes the determination of managerial incentives and the monitoring and assessment of organisational performance.<sup>118</sup>

### 2.4.2 Corporate Actions and Decisions

This role involves the continual checking of corporate financial results and prospects, including cash flow, profit and loss by major business segments. Under this role, the board focuses on assuring shareholders that, there is prior board consideration of any major commitment of corporate resources over a period of time.<sup>119</sup> 'Normally these corporate resource allocation decisions will be embodied in corporate strategic plans and board consideration of such plans should be an integral part of the strategic planning process.'<sup>120</sup> This role also includes advising the CEO on strategic plans for the company and the surveillance of management to ensure that shareholders receive the full value of their investments.

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<sup>118</sup> The Department of Trade and Industry and Kings College London, "Key Drivers of 'Good' Corporate Governance and the Appropriateness of UK Policy Responses" at 16 available at [www.dti.gov.uk/bbf/corp-gov-research/page15049.html](http://www.dti.gov.uk/bbf/corp-gov-research/page15049.html) [Accessed 1 April 2009]

<sup>119</sup> The Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, The Business Lawyer, July (1977-78)-Vol. 33 at 2099. Available at <http://www.heinonline.org/HOL/Page?handle=hein.journals/busl33&id=2159&collection=journals&index=journals/busl> [Accessed 2 July 2009].

<sup>120</sup> Ibid.

### 2.4.3 Corporate Social Responsibility

Another major board responsibility is the consideration of significant social impacts of corporate activities and relatedly the consideration of views of substantial groups (other than shareowners) significantly affected by such corporate activities.<sup>121</sup> As companies have developed over time, it is necessary that the board consider other interests besides those of the shareholders. Although the board is primarily responsible for steering the company to the benefit of its owners, such benefits cannot be conceived solely in terms of short-range profit maximization.<sup>122</sup> As companies have become so large to the extent that they influence the environment in which they operate, the owners of the companies have to balance short-range and long-term profitability. This may be done through considering the political and social viability of the enterprise over time and in adjusting to the global environment in which it operates.<sup>123</sup> As such, in carrying out its corporate social responsibility role, the board has to consider the overall impact of the activities of the corporation on (1) the society of which it is a part, and on (2) the interests and views of groups other than those immediately identified with the corporation.<sup>124</sup>

### 2.4.4 Compliance with the law

The board is also responsible for overseeing systems designed to ensure that the corporation obeys applicable laws, including tax, competition, labour, environmental, equal opportunity and health and safety laws.<sup>125</sup> The compliance role also involves formulating policies and procedures that promote compliance on a sustained and systematic basis by all levels of operating management. Here, the independent director is essential in ensuring the conformance and performance aspects of the board.

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<sup>121</sup> Ibid.

<sup>122</sup> Ibid.

<sup>123</sup> Ibid.

<sup>124</sup> The Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, July (1977-78) Vol. 33 *The Business Lawyer* at 2100.

<sup>125</sup> OECD *Guidelines on Corporate Governance for State-Owned Enterprises* at 58. Available at <http://www.oecd.org/documents> [Accessed 30 March 2009].

In essence, the major tasks of the unitary board are to manage the business collectively for the benefit of shareholders, stakeholders and to comply with the financial reporting and other disclosure requirements as laid down by the company law.<sup>126</sup> In carrying out its mandate, the board of directors is not only accountable to the company's shareholders, but also has a duty to act in their best interests. Every director of a company has a duty to act in good faith when acting on behalf of the company.<sup>127</sup> The above duties of a director are found under the common law and some have been codified under the new Companies Act.

## 2.5 Duties of a director

In South Africa, the core duties of a director are found in the common law and legislation. For instance, the current Companies Act obligates directors, to disclose any interests in company contracts.<sup>128</sup> The aim behind the above restrictions is to 'prevent directors of a company from acting in their own interest and against the interests of shareholders by burdening the company with obligations, not for its benefit, but for the director's benefit.'<sup>129</sup>

As the current South African Companies Act<sup>130</sup> did not clearly spell out the rules regarding corporate governance duties and liabilities of directors, these matters were largely left to the common law and to the codes of corporate practice, i.e. the King II.<sup>131</sup> In terms of the South African law and the King II, the predominant notion underlying each fiduciary relationship is loyalty.<sup>132</sup>

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<sup>126</sup> Pye and Camn, *Non –Executive Directors: Moving beyond the 'One-size-fits-all' View*, (2003) Vol. 28 Issue No.3 Journal of General Management at 57.

<sup>127</sup> Tshepo Mongalo, *Corporate Law & Corporate Governance: A Global Picture of Business Undertakings in South Africa*, (2003) at 160.

<sup>128</sup> For instance, section 243 of the Companies Act 61 of 1973.

<sup>129</sup> M.S. Blackman, R.D. Jooste, G.K. Everingham, *Commentary on the Companies Act*, (2002) Vol. 2 from 306-307.

<sup>130</sup> Act 61 of 1973.

<sup>131</sup> D. Davis et al *Companies and other Business Structures in South Africa* Oxford University Press Southern Africa, 2009 at 102

<sup>132</sup> Mongalo, Tshepo, *Corporate law and corporate governance: a global picture of business undertakings in South Africa*, (2003) at 161.

In terms of the common law, every director<sup>133</sup> of a company has the following fiduciary duties:

The duty to act in the best interests of the company, to avoid conflicts, to not take corporate opportunities or secret profits, to not fetter their votes and to use their powers for the purpose not conferred and not for a collateral purpose.<sup>134</sup>

A director is also subject to the duty of care, skill and diligence in the performance of his duties. The above duty is not a fiduciary duty, but it is an additional duty attached to directorship. The King III notes that:

Directors must manage the business of the company as a reasonably prudent person would manage his own affairs. The standard of care is a mixed objective and subjective test, in the sense that the minimum standard is that of a reasonably prudent person but a director who has greater skills, knowledge or experience than the reasonable person must give to the company the benefit of those greater skills, knowledge and experience.<sup>135</sup>

Davis et al<sup>136</sup> argue that, directors need to know their duties and must be aware of what is expected of them, because the standards of directors' conduct can influence the profitability, determine the extent of foreign and domestic investments, and ultimately determine the success of a company.

At times, an independent director is often appointed to represent special interests on the board, for instance major shareholders. However, in terms of the common law such a director is bound to act in the best interests of all shareholders. In other words, the board is collectively responsible to all

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<sup>133</sup> As shall be discussed later in the dissertation the duty applies to all directors irrespective of whether one is an executive director or non-executive director.

<sup>134</sup> King III at 12. Available at <http://www.iodsa.co.za>.

<sup>135</sup> King III. Available at <http://www.iodsa.co.za>.

<sup>136</sup> D. Davies et al *Companies and other business structures in South Africa*, (2009) at 102.



shareholders and not to any particular shareholder or constituency body. The above principle was noted in the case of *Fisheries Development Corporation of SA Ltd v. Jorgensen*<sup>137</sup>. In the above case, the court noted that,

A director is in that capacity not the servant or agent of the shareholder who votes for or otherwise procures his appointment to the board...<sup>138</sup> The court went further to note that, 'the director's duty is to observe the utmost good faith towards the company, and in discharging that duty he is required to exercise an independent judgment and to take decisions according to the best interests of the company as his principal.'<sup>139</sup> In addition to the above the director, 'may in fact be representing the interests of the person who nominated him,... but, in carrying out his duties and functions as a director, he is in law obliged to serve the interests of the company to the exclusion of the interests of any such nominator, employer or principal.'<sup>140</sup>

Essentially, when an independent director carries out his duties, he is expected to do this in a manner that represents and protects all shareholders' interests on the board.<sup>141</sup> That is to say, the independent director should treat all shareholders equally and not give preference over a shareholder or group of shareholders.

The new South African Companies Act<sup>142</sup> has codified some of the common law duties of a director. Davis et al notes that, the codified duties are subject to, and not in substitution for the directors' duties in terms of the common law. The effect of the above is that the 'courts still have regard to the common law, including past case law when interpreting the provisions of the new

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<sup>137</sup> 1980(4) SA 156.

<sup>138</sup> *Fisheries Development Corporation of SA Ltd v. Jorgensen* 1980(4) SA 156 at 157.

<sup>139</sup> Ibid.

<sup>140</sup> Ibid.

<sup>141</sup> Eric M. Fogel and Andrew M. Geier, *Strangers in the house: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, Delaware Journal of Corporate Law (2007) at 60. Available at [http://www.lexisnexis.com/us/Inacademic/results/docview/docview.do?docLinkInd=true&risb=21\\_T6904056996&format=GNBFI&sort=BOOLEAN&startDocNo=1&resultsUrlKey=29\\_T6904056999&cisb=22\\_T6904056998&treeMax=true&treeWidth=0&csi=138474&docNo=5](http://www.lexisnexis.com/us/Inacademic/results/docview/docview.do?docLinkInd=true&risb=21_T6904056996&format=GNBFI&sort=BOOLEAN&startDocNo=1&resultsUrlKey=29_T6904056999&cisb=22_T6904056998&treeMax=true&treeWidth=0&csi=138474&docNo=5) [Accessed 6 June 2009].

<sup>142</sup> Section 76 of the new Companies Act No 71 of 2008.

Companies Act.<sup>143</sup> One of the reasons behind the codification the director's duties is to create certainty and accessibility of the director's duties. In the United Kingdom similar codification of director's duties have also taken place. Reasons for codifying include making development of the law in this area more predictable (but without hindering development of the law by the courts). For the purposes of this research, I shall not discuss in detail how each duty of the director operates, as that would be going outside the scope of the topic.

In summary, this chapter discussed the role and composition of the board of directors in line with the King II recommendations. Under this discussion, we observed that South Africa has largely adopted a unitary board system, which brings together the executive and non-executive directors. The chapter also highlighted some of the King II recommendations such as having a board, which is composed of a majority independent directors and the need to have a split role between the CEO and the chairperson. From there, the chapter also looked at the main role of the board. The roles that were discussed include engaging in corporate social responsibility and corporate decisions making. Lastly, the chapter briefly discussed the duties of director. The next chapter analysis the concept of an independent director and attempts to explain the concept before looking at his role in corporate governance.

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<sup>143</sup> D. Davies et al *Companies and other business structures in South Africa*, (2009) at 103.

## CHAPTER 3: THE CONCEPT OF AN INDEPENDENT DIRECTOR

### 3.1 Introduction

The independent director is often appointed to provide a breadth of experience and specialist knowledge that may present the board with valuable insights or key contacts in related industries.<sup>144</sup> Additionally, the independent director may possess certain personal qualities that may assist the board in carrying out its functions.<sup>145</sup> Most importantly, the independent director is appointed because of his independence of management and any of its interested parties.<sup>146</sup> That is to say, the independent director can bring a degree of objectivity to the board's deliberations and play a valuable role in monitoring executive management.

Generally, most legislation<sup>147</sup> does not distinguish the executive director from the independent director or non-executive director. In other words, such legislation does not distinguish between the two directors for the purposes of ascertaining the duties they owe to the company, as the independent director is subject to the same duties as the executive director.<sup>148</sup> The law expects both directors to discharge their duties as a collective body.<sup>149</sup> As an aside, although all directors may seem to have the same legal responsibilities, the very existence of the independent director implies that his role is in some way different to that of the executive directors.<sup>150</sup> Stapledon asserts that, the key difference between the two directors mainly arises out of the monitoring role fulfilled by independent directors.<sup>151</sup>

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<sup>144</sup> The Role of a non-executive director at 1. Available <http://www.iod.com/intershoproot/eCS/Store/en/pdfs/roleofnxd.pdf> [Accessed 25 June 2009].

<sup>145</sup> Ibid. Personalities such as good character, and the right attitude

<sup>146</sup> Ibid.

<sup>147</sup> Here, I refer to legislation found in countries that share a similar corporate governance system with South Africa. For example, the Australia, UK and USA.

<sup>148</sup> *Howard v Herrigel* 1991 (2) SA 660 (A) at 661H.

<sup>149</sup> Ibid.

<sup>150</sup> G.P. Stapledon, *Institutional Shareholders and Corporate Governance*, (1996) at 144.

<sup>151</sup> Ibid.

### 3.2 The Director under South African Law

The current Companies Act defines a director as including, 'any person occupying the position of director or alternate director of a company, by whatever name he may be designated.'<sup>152</sup> The new Companies Act also carries a very similar definition, which states that, a director is a member of the board of a company or alternate director of a company or any person occupying the position of a director by whatever name designated.<sup>153</sup>

From the above definitions, it is interesting to note that the current Companies Act 'seems to imply that, a person who does not carry the title of a director, but is *de facto* acting as a director could be treated as a director for the purposes of the Act.'<sup>154</sup> The purpose of the above provision may be to avoid corporate officers escaping liability for wrongful acts committed while acting in the capacity of a director, but without necessarily holding the title of a director. Furthermore, from the above definitions, we also note that both pieces of legislation do not carry a definition that distinguishes between an executive director and an independent director.

The court in *Howard v Herrigel*<sup>155</sup> noted that there is no real distinction in law between the executive director and non-executive director as both are subject to the same duties. In this case, the court also noted that:

It is unhelpful and even misleading to classify the company directors as executives or non-executives (Independent Director) for the purposes of ascertaining their duties to the company... No such distinction is to be found in any statute. At common law, once a person accepts an appointment as director, he becomes a fiduciary in relation to the company and is obliged to display the

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<sup>152</sup> Section 1 of the Companies Act No 61 of 1973.

<sup>153</sup> Section 1 of the Companies Act No 71 of 2008.

<sup>154</sup> Wixley and Everingham, *Corporate Governance* (2002) at 17.

<sup>155</sup> 1991 (2) SA 660 (A).

utmost good faith towards the company in his dealing on its behalf.<sup>156</sup>

The Court went further to note that ‘...it also is not helpful to say of a particular director that, because he was not an executive director his duties were less onerous than they would have been if he had been an executive director.’<sup>157</sup> Whether the enquiry is one in relation to negligence, reckless conduct or fraud, the legal rules are the same for all directors.<sup>158</sup> However, the expected standard of care is higher for executive directors who have a service contract with the company and transact with the company on a regular basis as compared to an independent director.

In similar jurisdictions such as the UK, the Companies Act<sup>159</sup> defines a director as including any person occupying the position of director by whatever name called, but does not distinguish between an executive director and a non-executive director. The court in *Dorchester Finance Co v Stebbing*<sup>160</sup>, when called upon to decide the liability of a non-executive director, noted that a director in carrying out his or her duties was required to exhibit... a degree of skill as may be reasonably be expected from a person with his or her knowledge and experience. The director was also required to take such care as an ordinary person might be expected to take and must exercise any power vested in him with good faith and in the company’s interest. Most importantly, the court noted that in applying the above standards no distinction is to be drawn between the executive and non-executive directors.<sup>161</sup>

From the above case law, we observe that, the independent director is equally liable in law as the executive director. Most importantly, we also note

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<sup>156</sup> 1991 (2) SA 660 (A) at 661H.

<sup>157</sup> Ibid.

<sup>158</sup> 1991 (2) SA 660 (A) at 661I

<sup>159</sup> Section 250 of United Kingdom’s Companies Act 2006 Chapter 46

<sup>160</sup> 1989 Butterworth Company Law Cases 498.

<sup>161</sup> (1989) Butterworth Company Law Cases 498 at paragraph e-f.

that, in law there is no clear distinction between the executive director and the non-executive director. Below is a brief comparative analysis of how the current Companies Act and the new Companies Act attempt to define the independent director and the tests for the independence of a director under South African law.

### **3.2.1 The independent director under the current Companies Act**

The closest attempt to define an independent director is found under s 269A 4(b) (i)-(ii) of the current Companies Act, which deals with members of the audit committee. In terms of this section, a non-executive director is a director who is not involved in the day-to-day management of the company and has not been in full-time employment with the company in the last three years.<sup>162</sup> In addition, such a director should 'not be a member of the immediate family of any individual who has been involved in the day-to-day management or been a full-time employee in the past three years.'<sup>163</sup>

In terms of the current Companies Act, a director acts independently through expressing his or her opinions, exercising judgement and making decisions impartially.<sup>164</sup> Furthermore, a director acts independently if that director is not related to the company or to any shareholder, supplier, customer or other director of the company in a way that would lead a reasonable and informed third party to conclude that, the integrity, impartiality or objectivity of that director is compromised by that relationship.<sup>165</sup>

The above essentially involves the inherent quality test and the relational test. The inherent quality tests in effect means a director must be impartial and independent when making decisions i.e. a director must not be biased towards a certain individual or individuals when making decisions. A drawback of the test is

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<sup>162</sup> Section 269A (4) (b) (i) of the Companies Act No 61 of 1973.

<sup>163</sup> Section 269A (4) (b) (ii) of the Companies Act No 61 of 1973.

<sup>164</sup> Section 269 (4) (c) (i-ii) of the Companies Act No 61 of 1973.

<sup>165</sup> Section 269 (4) (c) (ii) of the Companies Act No 61 of 1973. The Reasonable and informed third party test.

that it focuses on impartiality as a requirement for being independent and does not consider other qualities such as character, attitude and skills. It also leads us to believe that only certain directors need to be independent yet independence is a requirement for all directors. Lastly, the test has always existed in the common law and may not warrant incorporation into statute.

### **3.2.2 The independent director under the new Companies Act**

The new Companies Act focuses on features that are commonly attributed to a non-executive director as members of the audit committee such as, not been involved in the day-to-day management of the company's business. The new Companies Act also notes that the member of the audit committee 'must not be a material supplier or customer of the company, such that a reasonable and informed third party would conclude in the circumstances that the integrity, impartiality or objectivity of that director is compromised by that relationship.'<sup>166</sup>

A significant difference under the new Companies Act is that, it gives the Minister the power to prescribe additional requirements for members of the audit committee.<sup>167</sup> The new Companies Act has dropped the inherent quality test and focused on the compromising relation.

The above was a brief illustration of how local legislation has attempted to define the independent director. Below is an analysis of how the various codes have defined the independent director.

### **3.3 Defining the Independent Director through corporate governance codes**

In terms of the King II, a non-executive director is an individual not involved in the day-to-day management of the company and is not a full-time salaried employee

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<sup>166</sup> Section 94 (4) (iii) of the Companies Act No 71 of 2008.

<sup>167</sup> Section 94 (4) (a) of the Companies Act No 71 of 2008.

of the company or any of its subsidiaries.<sup>168</sup> The King II also gives reference to an independent director non-executive director. This director is not a representative of a shareowner and is able to control or significantly influence the management of the company. Furthermore, the King II notes that the company or the group, of which it currently forms part, must also not have employed the independent director in any executive capacity for the preceding three financial years.<sup>169</sup> In terms of the King II, the requirements to qualify as an independent non-executive director are slightly more onerous in comparison to those for one to qualify as a non-executive director.<sup>170</sup>

The King II sets out a vast number of compromising situations or relations the independent non-executive director may not be involved.<sup>171</sup> In comparison, the non-executive director only need not be in full time employment of the company and its subsidiaries or be involved in the day-day management of the company. Nonetheless, the underlying principle from the King II is that, both the independent director and non-executive director must have no material ties with the company on which they serve as directors. In other words, the director must be detached as much as possible from the company on which they serve as board members.<sup>172</sup>

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<sup>168</sup> King II Paragraph 2.4.3. Available at <http://www.iodsa.co.za> [Accessed 8 June 2009].

<sup>169</sup> King II Paragraph 2.4.3. Available at <http://www.iodsa.co.za> [Accessed 8 June 2009].

<sup>170</sup> The King II also goes further to list other compromising situations in which the Independent director should not be involved in like, paragraph 2.4.3 (IV). The director should not be a professional advisor to the company or the group, other than in a director capacity. Paragraph 2.4.3 (vii), the director should be free from any business or other relationship that could be seen to materially interfere with the individual's capacity to act in an independent manner.

<sup>171</sup> Ibid.

<sup>172</sup> The difference between the non-executive director and the independent non-executive director has largely remained the same under the draft King Three Report. In fact, the King III introduces a new director termed the lead independent director who provides leadership and advice to the board when the chairperson has a conflict of interest. For more information, consult King Three Report for Governance in South Africa at 50-51. Available at <http://www.iodsa.co.za>



The New York Stock Exchange Rules (Rules) stipulate all listed companies must have majority independent directors.<sup>173</sup> The Rules also state that, for a person to qualify as an independent director, the board of directors must affirmatively determine that the potential director has no material relationship with the listed company.<sup>174</sup> In addition, a director who is an employee or whose immediate family member is an executive officer, of the company is not independent until three years after the end of such employment relationship.<sup>175</sup> Moreover, the director or an immediate family member must not be a current partner of a firm that is the company's internal or external auditor.<sup>176</sup> The Rules go further to list other requirements that the potential director must meet before qualifying as an independent director, which I shall not list here but will discuss below in comparison with the other codes.

In Australia, the Principles of Good Corporate Governance and Best Practice Recommendations (Principles) govern director's independence. In the same manner as the King II and the Rules, the Principles list a number of requirements a person must meet before they may qualify as an independent director. Some of these requirements include, an independent director must not be a substantial shareholder of the company or be an officer of the company. The independent director must also within the last three years not have been employed in an executive capacity by the company or another group member, or been a director after ceasing to hold such employment.<sup>177</sup> The Principles also list

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<sup>173</sup> New York Stock Exchange, *Listed Company Manual*, s 303A.01. Available at <http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F4%5F3%5F1&CiRestriction=303A&manual=%2F1cm%2Fsections%2F1cm%2Dsections%2F> [Accessed 25 June 2009].

<sup>174</sup> Ibid.

<sup>175</sup> Ibid.

<sup>176</sup> New York Stock Exchange, *Listed Company Manual*, s 303A.01. Available at <http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F4%5F3%5F1&CiRestriction=303A&manual=%2F1cm%2Fsections%2F1cm%2Dsections%2F> [Accessed 25 June 2009].

<sup>177</sup> Australian Principles of Good Corporate Governance and Best Practice Recommendations (Principles), Principles Box 2.1 at 20. Available at <http://www.shareholder.com/shared/dynamicdoc/ASX/364/ASXRecommendations.pdf> [Accessed 25 June 2009].

five other factors that need to be taken into account in considering whether a director is independent.<sup>178</sup>

According to the Vienot Two Report of France, 'a director is independent when he or she has no relationship of any kind whatsoever with the corporation, its group or the management of either that is such as to colour his or her judgement.'<sup>179</sup> As such, an independent director must be one who is devoid of particular bonds of interest with any significant shareholder, employee or other.<sup>180</sup> The Vienot Two Report also lists the criteria used for a director to qualify as a non-executive director and for preventing conflicts of interests. For example, the director must not be an employee or corporate officer of the corporation, or an employee or director of its parent company or a company that it consolidates. In addition, the director must not have been in the above positions for the preceding five years.<sup>181</sup> Equally important, the Vienot Two Report requires that the director not have been an auditor of the corporation within the previous five years.

The U.K Combined Code<sup>182</sup> also lists a number of circumstances, the existence of which may be relevant in determining a director's independence. For a director to qualify as an independent non-executive director, that director amongst other factors, must not have been an employee of the company or

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<sup>178</sup> These factors include, within the last three years has not been a principal of a material professional adviser or a material consultant to the company or another group member, or an employee materially associated with the service provided; has not served on the board for a period which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company; is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company. Available at <http://www.shareholder.com/shared/dynamicdoc/ASX/364/ASXRecommendations.pdf> [Accessed 25 June 2009].

<sup>179</sup> Hopt et al, *European Corporate Governance in company law and codes, Report prepared for the European Corporate Governance Conference of October 18, The Hague, The Netherlands* at 17. Available at <http://corpgov.nl/at/downloads/Final%20Report2.pdf> [Accessed 14 June 2009].

<sup>180</sup> Ibid.

<sup>181</sup> Ibid.

<sup>182</sup> The United Kingdom's Combined Code provision A.3.1. Available at <http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf> [Accessed 20 March 2009]

group within the last five years. Furthermore, the director must not represent a significant shareholder and have no close family ties with any of the company's advisers, directors or senior employees.<sup>183</sup>

It is also worth noting that U.K Combined Code introduces the concept of a senior independent director. The purpose of the senior independent director is to act as an intermediary for 'shareholders if they have concerns of which contact through the normal channels of chairperson, CEO or finance director has failed to resolve or for which such contact is inappropriate.'<sup>184</sup> Similar provisions are also contained in the King II<sup>185</sup> and the Draft King III. The King III notes that a lead independent director's role is to provide advice to the board and lead the board in situation where the chairperson has a conflict of interest.<sup>186</sup>

A close analysis of the above codes reveals some important differences in the manner in which the codes define the independent director. Below is a comparative analysis of definitions emanating from the above-mentioned corporate codes.

### **3.4 A comparative analysis of the independent director definitions**

In assessing the materiality of a director's relationship, the Rules require the board to consider the issue not merely from the standpoint of the director, but also the person or organisations with which the director has an affiliation.<sup>187</sup> As such, in assessing the materiality of a director's relationship, the Rules encourage boards to adopt and disclose categorical standards to assist the board in making determinations of independence. The Rules also compel boards

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<sup>183</sup> The United Kingdom's Combined Code provision A.3.1. Available at <http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf> [Assessed 14 June 2009]. This provision also lists other factors that the board must take into account in considering director independence.

<sup>184</sup> Ibid at Provision A.3.3.

<sup>185</sup> King II Paragraph 2.6.3 Available at <http://www.iodsa.co.za>

<sup>186</sup> King III at 50-51. Available at <http://www.iodsa.co.za>

<sup>187</sup> Commentary on the New York Stock Exchange Rules (NYSE Rules). Available at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf> [Accessed on 8 June 2009].

to make a general disclosure if a director meets these standards.<sup>188</sup> Adopting categorical standards allows corporate boards certain latitude to determine director independence by considering the circumstances and relationships of director's individually. Similarly, the UK Combined Code requires boards to adopt categorical standards to be used to determine director independence. The Combined Code and the Rules approach, is advantageous in that it allows the board to take into consideration the varying circumstances surrounding each director's appointment instead of having an approach that is based on the premise that one shoe size fits all.

The Rules also provide that the basis for a board determination that a relationship is not material must be disclosed in the company's annual proxy statement.<sup>189</sup> Disclosing a categorical standard used to ascertain director independence provides investors with an opportunity assess the quality of the board independence while avoiding excessive disclosure of immaterial relationships and information.<sup>190</sup> In contrast, the King II requires no such disclosure on the basis that the board determined a relationship is immaterial. The King II only requires that the board ascertain that the individuals appointed to the board are fit and proper and are not disqualified from being directors. In addition, the King II requires that, in ascertaining whether the individuals are fit and proper, the director's background should be investigated along the lines of the approach required for listed companies by the JSE and under the Banks Act.<sup>191</sup> Equally interesting is that, other corporate codes from Australia, UK and France require no such disclosure or the basis of non-disclosure.

In contrast to the UK Combined Code, the King II and the Principles, the Rules introduce a three-year look back period. The three-year look back period applies when determining whether a director is independent using the categorical

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<sup>188</sup> Ibid.

<sup>189</sup> Ibid.

<sup>190</sup> Ibid.

<sup>191</sup> King II paragraph 2.4.8. Available at <http://www.iodsa.co.za> [Accessed 10 May 2009].

standard adopted by the board. The three-year look back provision entails that, the board must consider the director's relationships or interests in the three years immediately preceding the appointment.<sup>192</sup> However, when applying the look back provision, for example, listed companies need not consider individuals who are no longer immediate family members because of legal separation or divorce, or those who have died or become incapacitated.<sup>193</sup> The inclusion of the look back provision in the Rules may be attributed to the highly rule based Corporate Governance system approach adopted by the America. In similarity with the Rules, the Vienot Report has a similar provision although it provides for a longer look back period of five years.<sup>194</sup>

The similarities that may be drawn from the above codes are that, Principles and the King II require that the company or the group of which it currently forms, to not have employed the independent director in any executive capacity. In contrast, the Rules and the UK Combined Code note that an independent director must not have been an employee (including an executive) of the company. Ritchie asserts that, this is an important difference in that the Rules and the UK Combined Code essentially prevent non-executive employees of the company from becoming independent directors.<sup>195</sup> The advantage of the Principles and to a similar extent the King II is that, a company's senior non-executive employees could function effectively as directors. These senior non-executive employees are aware of the company's functioning at an operational level, and understand a company's day-to-day running which in turn gives them a greater ability to make sound decisions at a board level.

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<sup>192</sup> NYSE 'Final Rules' General commentary to s303A.02 (b). Available at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf> [Accessed on 8 June 2009].

<sup>193</sup> Section 303A.02 (b), of the NYSE rules, Commentary on the New York Stock Exchange Rules (NYSE Rules) at 6. Available at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf> [Accessed on 8 June 2009].

<sup>194</sup> Hopt et al, European Corporate Governance in company law and codes, Report prepared for the European Corporate Governance Conference of October 18, The Hague, The Netherlands at 17. Available at <http://corpgov.nl/at/downloads/Final%20Report2.pdf> [Accessed 14 June 2009].

<sup>195</sup> Thomas Ritchie, *Independent Directors: Magic Bullet or Band-Aid?* Corporate Governance eJournal. (2007) at 7. Available at <http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1004&context=cgej> [Accessed 25 June 2009].

The King II also notes that, an independent director must not be a professional advisor to the company or group, other than in a director capacity.<sup>196</sup> Similarly, the Principles state that, an independent director must not have been (within the last three years) a principal or employee of a material professional advisor or consultant.<sup>197</sup> However, under the Rules, an independent director is one who has not been within the last three years a partner or employee of that firm that performs the company's internal and or external financial audits.<sup>198</sup>

Arguably, the Principles and the King II are more advantageous in that, they encompass all 'material professional advisors which would include financial auditors, strategic consultants, media advisors, business advisors, and importantly lawyers, so long as their advice is material is material to the company.'<sup>199</sup> Essentially, under the Rules, a person may qualify as an independent director so as long as they never provided the company with audit services within the last three years. In contrast to the Rules, we note that the King II and the Principles take a more stringent view of a director's employment as a company consultant through encompassing all material advisors thus excluding such directors from appointment.

As an aside, we also note that the Rules only disqualify from appointment individuals who in the past have performed financial audit services for the company. This disqualification is primarily based on two reasons. Firstly, financial auditors have intimate knowledge of the company's financial data and it is

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<sup>196</sup> King II of 2002. paragraph 2.4.3(iv)

<sup>197</sup> Australian Principles of Good Corporate Governance and Best Practice Recommendations (Principles), Principles Box 2.1 at 20. Available at <http://www.shareholder.com/shared/dynamicdoc/ASX/364/ASXRecommendations.pdf> [Accessed 25 June 2009].

<sup>198</sup> New York Stock Exchange, *Listed Company Manual*, Rule 303A (iii) of NYSE Corporate Governance Rules. Available at <http://nysemanual.nyse.com/LCMTTools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F4%5F3%5F1&CiRestriction=303A&manual=%2F1cm%2Fsections%2F1cm%2Dsections%2F> [Accessed 25 June 2009]. Rule 303A (iii) of NYSE Corporate Governance Rules

<sup>199</sup> Thomas Ritchie, *Independent Directors: Magic Bullet or Band-Aid?* Corporate Governance eJournal. (2007) at 7. Available at <http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1004&context=cgej> [Accessed 25 June 2009].

essential that the auditing process remains independent of the company. Secondly, the Rules were promulgated in reaction to the corporate collapses in America, which were largely caused by poor or biased financial auditing.<sup>200</sup> Nonetheless, the Rules provide greater certainty through specifically referring to financial auditors, in comparison to the King II and the Principles that give reference to material advisors, which may be problematic in interpreting what constitutes a material advisor.

What mainly emanates from the above definitions is that, the independent director is an individual who should not have any material ties with the company in which the directorship is held. However, what the various codes seem to omit from the definitions is that independence is more of a state of mind than an objective fact and perception.<sup>201</sup> There is a clear lack of attention to soft factors of independence, like the character and attitude of the individual. Instead, the definitions mainly on the structure that amounts to director independence. For instance, an independent director cannot be an active or previous employee or member of management, a representative of shareholder, a professional adviser, supplier, and customer or closely related to the previous parties.<sup>202</sup>

However, there are some codes, which recognise that independence is not only a formal issue but also one that has largely to do with the director's character, attitude and personality towards the company.<sup>203</sup> For example, the United Kingdom's Combined Code differs from other codes in that it takes into account certain soft issues the board must consider when appointing an independent director. The UK Combined Code states that,

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<sup>200</sup> Ibid.

<sup>201</sup> King III at 50 available at <http://www.iodsa.co.za>. [Accessed 12 April 2009].

<sup>202</sup> L.A.A. Van den Berghe and Tom Baelden, *The Complex Relation between Director Independence and Board Effectiveness*, (2005) Vol.5, N0.5 Corporate Governance 59 at 59.

<sup>203</sup> For instance the United Kingdom's Combined Code which gives reference to a directors attitude, character in the appointment of an independent director.

The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement.<sup>204</sup>

The UK Combined Code illustrates that, it is important for independence to not only focus on the structural issues, but also highlight the importance of the soft issues such as character, attitude and integrity.

Although it may be extremely difficult to legislate on the soft characteristics or soft issues an independent director must possess, measures should still be put in place to examine the independence of the director before appointment. Such an examination may involve analysing the potential director's personal record of integrity and moral character. The fact that a 'person under consideration seems to care a lot about his or her own reputation will influence the potential director's willingness to do the job right.'<sup>205</sup>

Having discussed how legislation and corporate codes define the independent director, the next part of this dissertation examines the role of the independent director in corporate governance.

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<sup>204</sup> The United Kingdom's Combined Code provision A.3.1. Available at <http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf> [Assessed 14 June 2009].

<sup>205</sup> L.A.A. Van den Berghe and Tom Baelden, *The Complex Relation between Director Independence and Board Effectiveness*, (2005) Vol.5, N0.5 Corporate Governance 59 at 67. Available at <http://www.emeraldinsight.com/Insight/viewContentItem.do> [Accessed 20 March 2009]



## 3.5 The role of the Independent Director

### 3.5.1 Introduction

In terms of legislation, neither the current Companies Act nor the new Companies Act, clearly spell out the role of an independent director except as members of the audit committee. Similarly, in other jurisdictions like the USA, the SOX, 'has no role for a non-executive director other than as an audit committee member...' <sup>206</sup>

As legislation does not clearly define the role of the independent director, the duty is upon the company through its Memorandum of Incorporation or Articles of Association to set out what the company expects from the independent director. However, the role bestowed upon the independent director in terms of the Articles of Association or Memorandum of Incorporation must not conflict with the Companies Act or other legislation regulating companies.

In carrying out his mandate, the independent director is not required to possess entrepreneurial qualities, but is expected to challenge the thinking of the board of directors and bring commercial skill and experience to the board decision-making process.<sup>207</sup> In other words, the independent director should be willing and be able to ask the board difficult questions relating to board operations to ensure that decisions are sensibly thought through before the board adopts them. Moreover, in carrying out this mandate, corporate governance expects the independent director to ensure the board pays attention to the interests of minority shareholders who may not have board representation.<sup>208</sup>

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<sup>206</sup> Donald C. Clarke, *Three concepts of the Independent Director*, (2007) Volume 32, Number 1 *Delaware Journal of Corporate Law*, 80 at 87.

<sup>207</sup> Mervin Messias, *Non-executive Directors*, Gauteng Law Council. Available at <http://www.gautenglaw.co.za/content/index.cfm?navID=7&itemID=72> [Accessed 9 June 2009].

<sup>208</sup> Ibid.

Generally, the independent director's role involves participating as a board member, executing the board mandate and bringing a wider experience and new ideas to board discussions. The independent director is also expected to focus on board matters and avoid straying into the work of executive management, as this may cloud the director's objectivity thus leading him into not being able to provide an independent view of the company operations.<sup>209</sup>

The independent director also has the general responsibility of acting as an advisor to the management of the company and ensuring that management operates the company in the best interests of its owners. The above involves the independent director playing an accountability role, which involves monitoring management.

The role of the independent director also involves acting as a whistle blower, ensuring adherence to good corporate practices and respect for the interests of the other stakeholders.<sup>210</sup> In essence, the above means the independent director's main roles are, monitoring executive management and ensuring compliance to good corporate governance practices.<sup>211</sup> Below is a detailed analysis of the roles of the independent director.

### **3.5.2 Monitoring Role**

As a starting point, the board fulfils a pivotal role in corporate governance through monitoring top management by establishing various mechanisms (e.g. remuneration committees) that mitigate the incentives for managers to act opportunistically. Naturally, the independent director assumes the monitoring role, as inside or executive directors are part of the management team and hence cannot monitor themselves. In carrying out this monitoring role the independent director attempts to ensure that the actions of the CEO and other

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<sup>209</sup> Ibid

<sup>210</sup> Ibid.

<sup>211</sup> However, some of the main specialist roles of a non-executive director will be carried out in a board sub-committee, for instance the audit committee, remuneration committee and nomination committees.

executive directors pursue shareholder interests.<sup>212</sup> Dixon et al assert that, the independent director is as effective as a monitor when he asks tough questions to executives. In other words, the independent director should be willing and able to question executives over decisions they make on behalf of the company. Furthermore, as a vigilant outside monitor, the independent director can provide an independent judgement in areas that affect the executive directors, such as remuneration<sup>213</sup>, appointments and dismissals.<sup>214</sup>

It is important that an independent director's vigilance extend to legally problematic self-dealing between the controlling shareholder and the corporation. That is to say,

An independent director's alertness and willingness to question and object may lead a controlling shareholder to abandon a proposed course of action or to undo what has already been done.<sup>215</sup>

De Mott asserts that, vigilance in the above form also forces the hand of a recalcitrant controlling shareholder by forcing an explicit confrontation. A controlling shareholder who retaliates against a vigilant independent director, for example by removing the director from the board, has taken a visible step that may attract unwanted external attention. This risk may inhibit retaliation or channel it into less immediate or visible measures.<sup>216</sup>

At times, the monitoring role of the independent director has been criticised, as 'there has been an over-emphasis on the monitoring role of the

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<sup>212</sup> Rob Dixon, Keith Milton and Anne Woodhead, *An investigation into the role and effectiveness and future of non-executive directors*, Journal of General management Vol. 31 No.1 Autumn 2005 at 3.

<sup>213</sup> As shall be discussed later in this dissertation, the monitoring role of the independent director is very important in attempting to curb excessive executive remuneration.

<sup>214</sup> Note 211 at 3.

<sup>215</sup> DeMott, Deborah A. "Guests at the table? Independent directors in family-influenced public companies. " (Summer 2008): 33.4 819 The Journal of Corporation Law. Academic One File. Gale. Available at <http://www.find.galegroup.com/itx/infomark.do?&contentSet=IAC-> [Accessed 2 June 2009].

<sup>216</sup> Ibid.

independent director.<sup>217</sup> Due to this over emphasis, 'considerable management time has been spent providing the independent director with detailed information to questions and justification for strategies.'<sup>218</sup> The above has over burdened management, which in turn has diverted management from its core duties of running the company. However, there is currently limited evidence to support the hypothesis that accountability and monitoring constrains the enterprise.<sup>219</sup>

The monitoring role has also been criticised on the grounds that, it may create a possible. For example,

If non-executive directors... gain real experience over time and are able to do the job efficiently, they avoid liability but they may not be independent and their role may conflict with the executive functions of the chief executive officer.<sup>220</sup>

That is to say, at times when the independent director serves for long periods on boards, he tends to gain a substantial amount of experience and begin to encroach into the daily affairs of the company, which are ideally reserved for the executives. This encroachment may lead to a strain in the relationship between the independent director and other executive directors. Furthermore, independent directors who act as whistle blowers, stand to destroy any working relationship that the independent director has with the executive management.

### 3.5.3 Strategy Development

Flowing from the monitoring role, the independent director is also tasked with the role of strategy development. The board is collectively involved in the strategy formulation, setting of policies and acquiring and redistributing resources within

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<sup>217</sup> Note 211 at 3.

<sup>218</sup> Ibid.

<sup>219</sup> Ibid.

<sup>220</sup> Margariat Sweeney-Baird *The role of the non-executive director*, (2006) Vol. 27 No. 3 The Company Lawyer at 70.

the company. The independent director assists in strategy formulation through 'bringing a breath of vision, experience, environmental scanning and being available as a sounding board for the CEO.'<sup>221</sup> In carrying out the strategy development role, the independent director may be helpful through possessing a clearer or wider view of external factors affecting the company and its business environment than the executive directors.

The role and contribution of the independent director towards strategy formulation may at times be limited depending on the director's 'skill and motivation or contextual factors such as changing board dynamics.'<sup>222</sup> For instance, the independent director may be willing to assist in strategy development, but may be unable to do so due to board dynamics such as a domineering chairperson who imposes his or her ideas on the board.<sup>223</sup>

#### **3.5.4 Negotiation and Conflict resolution**

Companies expect the independent director to mediate in conflict of interest situations, for instance between management and the shareholders or between board members and the shareholders. Ideally, if any of the above situations were to unfold, the company forms a committee consisting of independent directors to assess the situation. The independent director also assists in controlling conflict of interest in areas such as CEO compensation and succession as it is often very difficult for an executive director to be adverse to a sitting CEO.

An independent director also plays a negotiation role on behalf of public shareholders, for instance, when the controlling shareholder proposes to cash out the public equity in an ongoing-private transaction. The negotiating role is largely dependent on how tactful the director is in negotiating and whether he is

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<sup>221</sup> Rob Dixon, Keith Milton and Anne Woodhead *An investigation into the role and effectiveness and future of non-executive directors*, Journal of General management Vol. 31 No.1 Autumn 2005 at 2.

<sup>222</sup> Ibid at 3.

<sup>223</sup> Board dynamics affecting directors will be dealt with under the topic relating to challenges faced by independent directors.

able to reject the transaction. Here, we note that the director's character and experience are important in order for the director to negotiate effectively. The negotiation role of the independent director is also very important when it comes to negotiating the remuneration package for the CEO.<sup>224</sup>

### 3.5.5 Communication Role

The board may benefit from outside contacts and opinions. An important function of the independent director can therefore be to help connect the business and board with networks of potentially useful people and organisations. In some cases, due to the outside contacts the independent director possess, the company may call upon the independent director to represent the company externally.<sup>225</sup>

From a different perspective, whilst on the audit committee, the independent director fulfils a communication role between the external auditors and board of directors. Here, the independent director assists in facilitating the easy flow of information to the board of directors to enable them to carry out their respective mandate.

Barratt et al<sup>226</sup> assert that, the independent director acts as a boundary spanner, spanning the boundary between the organisation and its environment. Barratt et al further argue that, the independent director assists in feeding back information about stakeholders' wants and needs, whilst simultaneously feeding out information to stakeholders about the organisation.<sup>227</sup>

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<sup>224</sup> This point will be expounded on under the heading dealing with executive remuneration in chapter 4.

<sup>225</sup> The role of the non-executive director .Available at

<http://www.iod.com/intershoproot/eCS/Store/en/pdfs/roleofnxds.pdf> [Accessed 1 July 2009].

<sup>226</sup> Ruth Barratt and Nada Korac-Kakabadse *Developing reflexive corporate leadership. The role of the non-executive directors.* (2002) Vol. 2, Issue 3 *Corporate Governance* 32-36 at 33 available at

<http://www.emeraldinsight.com.1472-0701.htm>. [Accessed 5 April 2009].

<sup>227</sup> Ibid at 33.

The above may assist in promoting transparency within the organisation through facilitating the free flow of information. Transparency is a key element of good corporate governance as it allows the board, shareholders and stakeholders to interact freely without fearing that certain information is being withheld. As noted above, to encourage further transparency, the independent director is 'sometimes employed specifically to attend to certain stakeholder group, which gives the independent director a unique perspective on stakeholder management.'<sup>228</sup> On the other hand, independent director needs to proceed with caution, as the above initiative is likely to lead to role conflict particularly if expectations are not clearly defined within the governance mechanisms of the organisation.<sup>229</sup> As such, there is need to clearly define the expectations of the independent director when carrying out this mandate.

### **3.5.6 General factors influencing the role of the independent director**

Although the independent director has three main roles, there are also a range of contextual or environmental factors that may shape and influence the roles and expectations of the independent director.<sup>230</sup> These factors include the extent of regulation within the industry, the presence of influential stakeholders outside the organisation and the potential for mergers and acquisitions activity.<sup>231</sup>

Regarding the extent of regulation within the industry, the growth in number and scope of Regulatory bodies in the UK has had an impact on organisations. For instance, UK Finance directors often comment on the ever-increasing power and numerous regulations and responsibilities cast upon them by the Financial Services Authority.<sup>232</sup> The ever-growing power of such a body

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<sup>228</sup> Ibid at 33.

<sup>229</sup> Ibid at 33.

<sup>230</sup> Annie Pye and Gillian Camn *Non-Executive Directors: Moving beyond the 'One-size-fits all' View*, (Spring 2003) Vol. 28 No.2 Journal of General Management 51 at 54.

<sup>231</sup> Ibid 54-55.

<sup>232</sup> The Financial Services Authority (FSA) is an independent non-governmental body, given statutory powers by the Financial Services and Markets Act 2000 of the United Kingdom. The FSA's mandate is to regulate the financial services industry in the UK. For more information on the FSA please visit <http://www.fsa.gov.uk/pages/About/What/Who/index.shtml> [Accessed 2 September 2009].

has an impact on the roles and expectations of board members.<sup>233</sup> For example, the independent director may have to carry out more vigilant monitoring to ensure that the company complies with all the regulations from the Financial Services Authority.

Another factor influencing the role of the independent director is the presence of active stakeholders outside the organisation. For example, stakeholders such as environmental lobbyist and corporate social responsibility campaigners may influence the manner in which the board carries out its functions.<sup>234</sup> These lobbyists and corporate social responsibility campaigners compel companies to be aware of and respond adequately to social needs of society. The King II notes that companies need to be non-discriminatory, non-exploitative and be responsible with regard to environmental and human rights issues, which in turn has the potential to increase productivity and corporate reputation.<sup>235</sup> As such, the above increases the monitoring role of the independent director, as the director needs to ensure that the company is operating in a sustainable manner, which is cognisant of the society.

The figure below attempts to show the influence the independent director has in the corporate governance setup of an organisation. The independent director being at the centre of the company acts as a link between the company and outsiders. Additionally, by being at the centre of an organisation, the figure highlights the mediation or negotiation role the director undertakes in an organisation. Moreover, it also attempts to draw attention to the personal attributes an independent director must possess in order to be effective in carrying out his role.<sup>236</sup>

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<sup>233</sup> Ibid at 54.

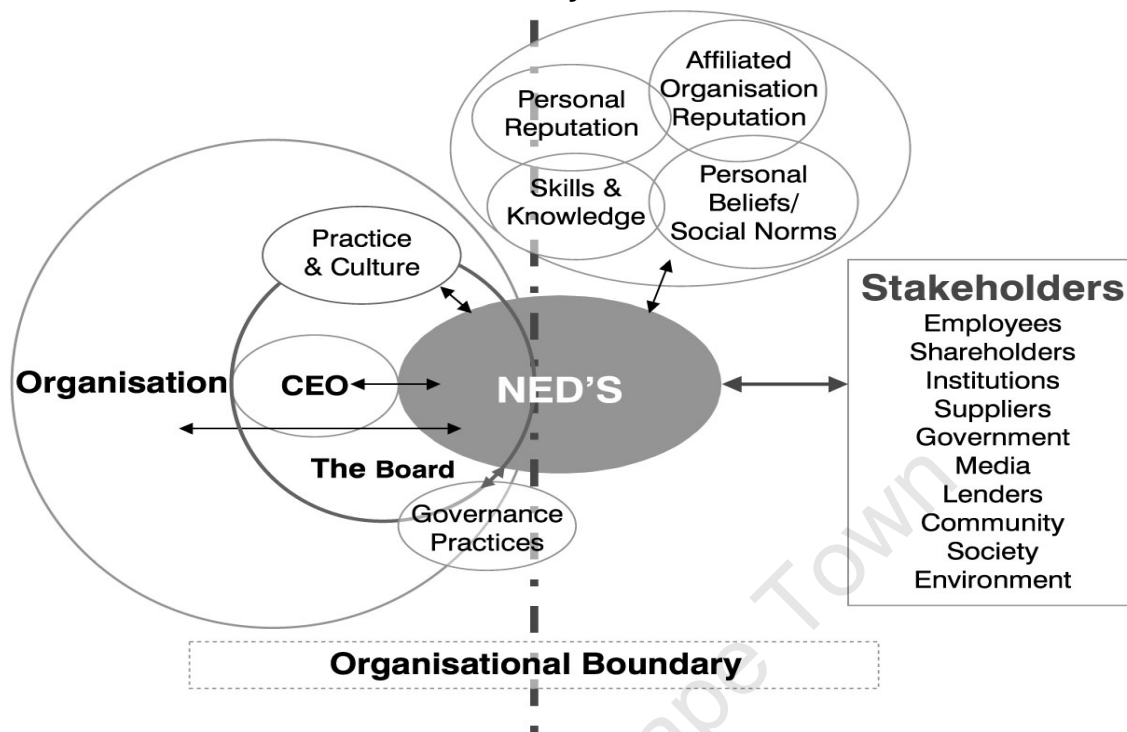
<sup>234</sup> Ibid

<sup>235</sup> King II at Paragraph 18.7.

<sup>236</sup> Ibid at 34.



### 3.5.7 Non-Executive Director Boundary Influencers<sup>237</sup>



**Source:** Compiled by authors

From this chapter we note that, most corporate codes tend to define the independent director as an individual not involved in the day-to-day operations of the company and one who has no material relation with the company. We also observed that, the independent director has three primary roles, which are monitoring management, strategy development, and communication roles. Furthermore, the role and expectations of the independent director are influenced by the extent of regulation within the industry and presence of active stakeholders outside the organisation.

The next chapter provides a detailed analysis of how the independent director carries out the above-mentioned roles on board committee.

<sup>237</sup> Ibid at 34.

## CHAPTER 4: THE INDEPENDENT DIRECTOR IN ACTION

### 4.1 Audit Committee

'The audit committee is a subcommittee of the board of directors, without executive powers, which oversees the internal and external audit process of the firm.'<sup>238</sup> Its role is to,

Maintain a continuing review of the corporation's financial data and to ensure that the firm has adequate internal controls, appropriate accounting policies, and ensure that external auditors deter fraud and promote high quality and timely financial statements.<sup>239</sup>

In South Africa, the current Companies Act<sup>240</sup> and the new Companies Act<sup>241</sup> require certain companies to have audit committees<sup>242</sup>. Similarly, the King II also recommends that companies have audit committees.<sup>243</sup> The statutory role of the audit committee as per the new Companies Act is, amongst other things, to nominate for appointment the companies external auditor, prepare a report to be included in the annual financial statements for that financial year and pre-approve any agreement for non audit services.<sup>244</sup> In essence, it ensures that the financial data of the company is accurately presented.

Ensuring the proper representation of financial data is an important indication of company's financial health. As the financial data represents the financial health of the company, the audit committee, through the monitoring role played by the independent director ensures that management is not tempted into presenting a rosy picture of the company's performance through modifying the

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<sup>238</sup> M. Willekens and P Sercu, *Corporate Governance at the Crossroads*, (2005) at 35.

<sup>239</sup> Ibid.

<sup>240</sup> Section 269A of the Companies Act No 61 of 1973.

<sup>241</sup> Section 94 (2) of the Companies Act No 71 of 2008.

<sup>242</sup> For instance, widely held companies must have an audit committee.

<sup>243</sup> King II, paragraph 6.3; as per paragraph 6.3.1-2, the committee should consist of a majority of independent non-executive directors who should be financially literate, furthermore an independent non-executive should chair the committee and the chairperson of the board may attend committee meetings by invitation.

<sup>244</sup> For more statutory duties of the audit committee see S.94 (7) (a-i) of the Companies Act No 71 of 2008.

numbers and thus avoiding incisive questions from the board as to its performance.<sup>245</sup> Furthermore, through overseeing the firm's financial reporting process, the independent director assists in preventing fraudulent accounting practices.

The audit committee has two potential advantages, which are independence and board efficiency. Independence is an essential requirement for any board committee to function effectively. 'The independence and integrity of monitoring may be enhanced by having both internal and external auditors report to a subset of the board that consists of outside directors.'<sup>246</sup> Therefore, to allow the independent director to carry out effectively his monitoring and compliance role in the audit committee, it is essential that the committee be composed of independent directors who are truly independent, willing and able to do the work.<sup>247</sup> That is to say, audit committee members should not be associated with management in order to allow the committee members to perform their oversight role and motivate external auditors to be impartial.<sup>248</sup>

The second advantage of the audit committee is that, 'board committees can help improve the efficiency of the board functioning as it can investigate problems in greater depth and detail than the entire board.'<sup>249</sup> In order to investigate problems in greater depth and detail, it is also essential that the independent director on the audit committee be financially literate. Financial literacy increases the likelihood that the independent director is able to recognise

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<sup>245</sup> A practice that has become commonly known as 'creative accounting.'

<sup>246</sup> Willekens and P Sercu *Corporate Governance at the Crossroads*, (2005) at 35.

<sup>247</sup> In this respect the King Report recommends that the committee be composed of a majority independent non-executive directors the chairman should be an independent non-executive director and not the Chairperson of the board, as per King II Report. The King II has placed more onerous requirements for members of the audit committee such as members should possess sufficient and relevant knowledge of corporate law, have a thorough understanding of the complexities of International Financial Reporting Standards, South African Statements of Generally Accepted Accounting Practice. Most importantly, the current Companies Act and the new Companies Act require that the audit committee be composed only of independent directors.

<sup>248</sup> M. Willekens and P Sercu *Corporate Governance at the Crossroads*, (2005) at 35.

<sup>249</sup> Ibid.

potentially misleading transactions or financial statements. In turn, the above contributes to high quality reporting. As an aside, if the independent director is financially independent of management, it also assists the director to withstand pressure to manipulate earnings.

From the above we note that, it is essential that the audit committee be independent to allow a 'high degree of active oversight and lower incidences of financial statement fraud.'<sup>250</sup> The Enron audit committee was a classical example of a committee that lacked independence and was often clouded with conflict of interest. The committee's non-executive directors failed to police their auditors due to serious conflicts of interest involving members of the audit committee. For instance, Wendy Gramm was the chairperson of Enron's audit committee and her husband, a senator, received substantial political donation from Enron. Furthermore, Lord Wakeham was on the audit committee at the same time as having a consultancy contract with Enron.<sup>251</sup> Surely, the above scenarios show that the people in the responsible positions, who should have detected the unethical activities, were themselves inadequately positioned to do so.

## 4.2 Remuneration Committee

Executive remuneration has generated a great deal of attention within the field of corporate governance. Especially after the revelation that the 'Enron board enjoyed remuneration packages of twice the national average for public corporations.'<sup>252</sup> In 2000, the directors of Enron were said to be receiving an annual fee of US\$350,000.<sup>253</sup> However, even after the revelations of Enron, executive remuneration has remained high. For instance, South African directors continue to receive lucrative excessive remuneration. In 2004, the average CEO's package was R4.3 million excluding share options, the average Chief

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<sup>250</sup> Ibid.

<sup>251</sup> Jill Solomon, Aris Solomon *Corporate Governance and Accountability* 2<sup>nd</sup> Ed (2007) Wiley, at 41.

<sup>252</sup> David Campbell and Stephen Griffin, *Enron and the end of Corporate Governance?* at 51. Chapter 3 in *Global Governance and the Quest for Justice* Vol 2, Corporate Governance.

<sup>253</sup> Ibid.

Financial Officer's (CFO) package was R2.6 million and the average executive director received a total package of R2.4 million.<sup>254</sup> In order to curb such excessive remuneration, most corporate codes recommend companies to set up remuneration committees.

The main task of the remuneration committee is to ensure that directors are appropriately rewarded for their work in a manner that will ensure as far as possible the recruitment, retention and motivation of people with the skills the company needs.<sup>255</sup> Furthermore, it is essential that, executive remuneration be structured so that, the executive's interests are aligned with those of the shareholders. For instance, stock based compensation for directors, which is restricted as to resale during their term in office, may enhance the alignment of director interests with those of shareholders.<sup>256</sup>

The King II recommends that the remuneration committee be composed entirely or mainly of independent non-executive directors.<sup>257</sup> Furthermore, the CEO of the company should play no part in determining his or her own remuneration. However, the CEO should be consulted to obtain his or her input regarding the remuneration of other directors.<sup>258</sup> Ideally, the responsibility for determining executive pay should be handled by independent directors as they have good knowledge of the company, and have no personal financial interest in the remuneration decisions they make.<sup>259</sup> Additionally, having a majority independent director on the remuneration committee allows the determination of executive remuneration to be viewed in a more detached way from the executive

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<sup>254</sup> C. Ncube, *A proposal for curbing excessive director's remuneration*, (2006) Vol. 20 No 2 Speculum Juris 253 at 259.

<sup>255</sup> Wixley and Everingham *Corporate Governance* (2002) at 67.

<sup>256</sup> Charles M. Elson, *Director Compensation and the Management Captured Board*; The History of a symptom and sure, at 326. Chapter 8 in *Corporate Governance, Law, Theory and Policy*. (2004).

<sup>257</sup> King II, Paragraph 2.5.2

<sup>258</sup> Ibid. In other words, the CEO may attend remuneration committee meetings y invitation only.

<sup>259</sup> Mongalo, Tshepo *Corporate law and corporate governance: a global picture of business undertakings in South Africa*, (2003) at 225.

directors.<sup>260</sup> At the same time, tasking the independent director with the responsibilities for recommending remuneration levels and packages also assists in controlling potential conflict and lends credibility to the committee recommendations.

However, despite tasking the remuneration committees with the responsibility of curbing executive remuneration, the remuneration levels remain high for a variety of reasons, of which some I have discussed below.

Firstly, the remuneration committees have often been regarded as been inefficient in that they lack the information, expertise and negotiating skills necessary for hard negotiations with incumbent and incoming executives.<sup>261</sup> For instance, some independent directors on the committee may lack the necessary negotiation tactics, including the power to reject the imposition of remuneration packages by a powerful CEO. Moreover, due to inadequate research into the competitive levels of pay, remuneration committees often transplant recommendations from the human resources department of which these recommendations are often those recommended by top management.<sup>262</sup>

Secondly, Mongalo T highlights that

The fact that non-executive directors who sit on the remuneration committee of one company are often executives of other companies and that when deciding on pay for the executives they [non-executive directors] will indirectly set the going rate for jobs of executives and this might ultimately affect them.<sup>263</sup>

In other words, given the manner in which the independent directors on the remuneration committee act, it may show that, they do not act independently

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<sup>260</sup> It is important to note that the remuneration committee only makes recommendation to the board on executive remuneration and the matter should be approved by the shareowners in the general meeting.

<sup>261</sup> Luiz, *An appropriate regime for the remuneration of executives*, (2006) Vol. 39 issue 1 Comparative and International Law Journal of Southern Africa 57 at 68.

<sup>262</sup> Ibid.

<sup>263</sup> Tshepo Mongalo, *Shareholder activism in the United Kingdom highlights the failure of the remuneration committee: lessons for South Africa*, (2003) 120 SALJ 756 at 762.

and apply their minds towards the recommendations they make on executive remuneration. In essence, the independent directors are being influenced by external factors such as the effect on the [independent directors] of the remuneration packages, they recommend for executives.

Thirdly, remuneration committees tend to rely on compensation consultants to assist in determining executive remuneration.<sup>264</sup> The major challenge with compensation consultants is that, the company management instead of the remuneration committee often hires these consultants. This has the potential of creating a conflict, as it is very difficult for these compensation consultants to make unbiased recommendations on executive remuneration.<sup>265</sup> The biasness of compensation consultants emanates from the fact that, compensation consultants obtain new clients based on their reputation, therefore it is always in their own personal interest to recommend high remuneration in order to attract more clients.<sup>266</sup>

### 4.3 Nomination Committee

The nomination committee is responsible for nominating individuals to serve on the firm's board of directors. Essentially, their duty is to assist the board of directors in the responsibility of nominating directors. The King II recommends that, the nomination committee be composed of the board chairperson and non-executive directors.<sup>267</sup> The purpose of having a nomination committee is to separate the board nomination process from other board members such as the CEO. Separating the nomination process from the main board also increases the

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<sup>264</sup> The King II, clause 2.7.8, allows board committees to access independent outside professional advice when necessary

<sup>265</sup> Luiz, *An appropriate regime for the remuneration of executives*, (2006) Vol. 39 issue 1 Comparative and International Law Journal of Southern Africa 57 at 69.

<sup>266</sup> Tshepo Mongalo, *Shareholder activism in the United Kingdom highlights the failure of the remuneration committee: lessons for South Africa*, (2003) 120 SALJ 756 at 762.

<sup>267</sup> King II paragraph 2.2.2

possibility that board appointees will be more willing to act as advocates for shareholders.<sup>268</sup>

A nomination committee composed of a majority of independent directors lessens the influence of executive directors who are likely to appoint individuals who are inclined to follow the instructions of the CEO and executive management. Evidence suggests that a nomination committee composed of a majority of independent directors is more likely to appoint individuals who are not associated with management and with the capacity to challenge the decisions of the executive directors.<sup>269</sup>

The nomination committee also serves to limit the appointment of nominee directors to the board. Institutional investors often appoint nominee directors for the purposes of acquiring inside knowledge of the company in which they would have invested. Acquiring inside knowledge of the company assists the investors to optimise their potential to safe guard their interests. However, a fundamental challenge with the above is that, ideally a nominee director should not take part in board processes in which a potential conflict of interest exists. Assuming the above principle is followed, the presence of the nominated director for the intended purpose becomes obsolete.<sup>270</sup> Thus, it is important that, the independent directors on the nomination committee nominate individuals that have the capacity to act as advocates for all shareholders.<sup>271</sup>

Having looked at the role of the independent director on the various corporate governance committees, we note that the independent director assists

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<sup>268</sup> Steven T. Petra, *Do outside independent directors strengthen corporate boards?* (2005) Vol. 5 No. 1 Corporate Governance, 55 at 56.

<sup>269</sup> Shivdasani, A. and Yermack, D, “*CEO involvement in the selection of new board members: An empirical analysis*”, *Journal of Finance*, (1998), Vol. 54 No. 5, pp. 1829-53. Quoted by Steven T. Petra, *Do outside independent directors strengthen corporate boards?* Corporate Governance Vol. 5 No. 1 2005, at 59.

<sup>270</sup> Chambers, Andrew D *Tolley's corporate governance handbook* (2002) at 403.

<sup>271</sup> Note 268 at 59.



in nominating directors who stand a greater chance of been shareholder advocates. We also note that, although to an arguable extent, the independent director assists in curbing executive remuneration. Now the question that arises is whether the roles fulfilled by the independent director add value to the company.

## **4.4 Does the Independent Director add value to the company?**

### **4.4.1 Introduction**

Many diverging views have emerged regarding whether the independent director adds value to company. The main debate concerning whether the independent director adds value to the company centres on two issues, firstly, whether there is a causal link between firm performance and board composition and secondly, what conditions produce better board performance?

Various studies have been conducted in an attempt to ascertain if the independent director adds value to corporate performance. For example, some studies have examined the 'composition of the board (i.e. management versus independent directors), and whether or not separating the positions of CEO and chairperson (i.e. CEO\Dualty) leads to improved firm performance.'<sup>272</sup> Other studies have 'examined the possible benefits to shareholders of boards that employ audit, compensation, and nominating committees composed entirely of outside independent directors.'<sup>273</sup>

In analysing the relation between director independence and board effectiveness, Van den Berghe and Baelden observed that, an independent director needs to possess certain qualities before being able to influence the performance of the corporation. Some of the qualities identified by the Van den Berghe and Baelden include that the independent director must possess the right attitude in order to be a vigilant monitor and objective decision maker. Van den

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<sup>272</sup> Note 268 at 56.

<sup>273</sup> Ibid.

Berghe and Baelden assert that, 'an independent director without the right attitude to think and act independently will not be an effective independent director.'<sup>274</sup> That is to say, for the independent director to add value to corporate performance, the independent director should have the ability and willingness to be probative, critical and as objective as possible.<sup>275</sup> Furthermore, both the ability and willingness to carry out the above complement each other in that, without the ability, a director will not know when to object or be probative. In turn without the willingness, the ability to exercise an objective judgment becomes obsolete.

Van den Berghe and Baelden also noted that the environment in which the independent director operates is equally essential in influencing whether the independent director adds value to corporate performance.<sup>276</sup> The authors note that, 'outside factors can block or stimulate the personal ability or willingness [of a director] to think and act independently.'<sup>277</sup> In the same vein, since the board is a collegial body composed of human beings operating in a social system, group dynamics and interpersonal relations are very influential towards the director's performance.<sup>278</sup> For instance, interpersonal relations are important in that board members should be able to trust and respect one another's judgment and expertise.

In support of the value the independent director brings, other studies carried out by Barnhart showed that, having more outside independent directors on the board improves firm performance.<sup>279</sup> Similarly, studies by Byrd and Hickman 'have shown that shareholders benefit more when independent

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<sup>274</sup> Van den Berghe and Baelden, *The complex relation between director independence and board effectiveness*, (2005) Vol. 5 No 5 Corporate Governance 58 at 63.

<sup>275</sup> Ibid.

<sup>276</sup> Ibid at 64.

<sup>277</sup> Ibid.

<sup>278</sup> Ibid

<sup>279</sup> Barnhart, S., Marr, M. and Rosenstein, S. "Firm performance and board composition: some new evidence" (1994) *Managerial and Decision Economics* Vol. 15 No. 4, pp. 329-40. Quoted by Steven T. Petra, *Do outside independent directors strengthen corporate boards?* (2005) Vol. 5 No. 1 Corporate Governance 55 at 57.

directors have control of the board in tender offers for bidders and in hostile takeovers.<sup>280</sup> Jensen and Meckling also suggest that, a board composed of a greater proportion of outside directors, due to their presumed independence may theoretically lead to better firm performance.<sup>281</sup>

In contrast, other studies have found no link between outside independent directors and improved firm performance.<sup>282</sup> These studies have also revealed that no association exists between the personal characteristics (i.e. college degree, firm, industry or other professional experience) of outside independent directors and better firm performance.

Having looked at the general studies regarding the influence of the independent director towards firm performance, below is a detailed analyses of studies carried out on the influence of the independent director towards firm performance in various sectors of the company.

#### **4.4.2 Audit Committees and Financial Statements**

Studies relating to the independent director and accurate financial reports vary greatly. Beasley conducted a research in which the results showed that, the presence of independent directors on audit committees did not increase the reliability of financial information.<sup>283</sup> For example, the Enron Corporation audit committee. This committee operated under the Securities Exchange Commission

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<sup>280</sup> Byrd, J. and Hickman, K, “*Do outside directors monitor managers? Evidence from tender offer bids*”, Journal of Financial Economics (1992) Vol. 32 No. 2, pp. 195-221. Quoted by Steven T. Petra, *Do outside independent directors strengthen corporate boards?* (2005) Vol. 5 No. 1 Corporate Governance, 55 at 57.

<sup>281</sup> Quoted by M.W. Peng, *Outside directors and firm performance during institutional transitions*, (2004) Vol. 25 Strategic Management Journal 453 at 453.

<sup>282</sup> Hermalin, B. and Weisbach, M. “*The effects of board composition and direct incentives on firm performance*” Financial Management, (1991), Vol. 20 No. 4, pp. 101-12. Quoted by Steven T. Petra, *Do outside independent directors strengthen corporate boards?* Corporate Governance Vol. 5 NO.1 2005, at 57.

<sup>283</sup> Beasley, M, “*An empirical analysis of the relation between board of director composition and financial statement fraud*” The Accounting Review (1996), Vol. 71 No. 4, pp. 443-65. Quoted by Steven T. Petra, *Do outside independent directors strengthen corporate boards?* (2005) Vol. 5 No. 1 Corporate Governance, 55 at 58

expanded rules on audit committee disclosure and composition. It was also headed by a widely respected accounting Professor and composed of highly respected academics.<sup>284</sup> Irrespective of the above, the Enron audit committee failed to recognise the accounting discrepancies and bring them to the attention of the board.

Another study carried out in the USA, which used a sample of 692 publicly traded firms to determine whether management earnings were related to audit committee independence showed that, management earnings were more pronounced in firms with audit committees composed of fewer independent directors. On the other hand, the research also showed that there was no relation between management earnings and the number of outside directors on the audit committee.<sup>285</sup>

In contrast, other studies have shown that an audit committee composed of majority independent directors enhances auditor independence and effectiveness as an independent audit committee allows for extensive exploration of problems.<sup>286</sup> A study of the first top 200 publicly traded Fortune 500 firms in the year 2000 showed that, an independent audit committee composed of majority expert independent directors<sup>287</sup> positively impacts on firm value.<sup>288</sup> Regarding board independence, the results also showed that, expert independence directors who control fifty per cent or more of the board enhance firm value. In the same vein, the authors argue that, the mere presence of the expert

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<sup>284</sup> Donald C. Clarke, *Three concepts of the Independent Director*, *Delaware Journal of Corporate Law*, (2007) Vol. 32, No 1, 52 at 75.

<sup>285</sup> April Klein, *Audit committee, board of director characteristics, and earnings management*, *Journal of Accounting and Economics*, (2002) Vol. 33, 375 at 376.

<sup>286</sup> McMullen, Dorothy Ann, *Audit Committee Performance: An Investigation of the Consequences Associated with Audit Committees*, *Auditing: A journal of Practice and Theory*, (1996) Vol. 15 No.1 at 88.

<sup>287</sup> The authors define an expert independent director as a Director who is a top executive of another publicly traded firm. *Supra* 288.

<sup>288</sup> Chan, Kam C, Li, Joanne, *Audit Committee and Firm Value: Evidence on Outside Top Executives as Expert-Independent Directors*, *Corporate Governance: An International Review* (2008) Vol. 16 Issue 1, 16 at 22.

independent director on the board does not that enhance firm performance, but it is also the control that the directors on the board have.<sup>289</sup>

#### 4.4.3 Remuneration

Studies on the effectiveness of the independent director in curbing executive remuneration also vary greatly.<sup>290</sup> In Australia a research was carried out in which the top 100 companies ranked by market capitalisation listed on the Australian Stock Exchange, were used to ascertain levels of executive remuneration. The research conducted sought to ascertain whether with an insider-influenced remuneration committee is prone to compensate the CEO any differently to a company with an independent remuneration committee.<sup>291</sup> The results of the study showed that, there was no evidence supporting the hypothesis that the relationship between corporate performance and CEO pay is stronger in companies with an independent remuneration committee compared to those with an insider-influenced remuneration committee.<sup>292</sup> Furthermore, a Henly College Management research carried out on 134 listed companies in 1997-2000 also found, amongst other things, that no relationship existed between company performance and the presence of a remuneration committee.<sup>293</sup>

#### 4.4.4 CEO/Duality

The King II recommends that, the position of the CEO and chairperson be separated.<sup>294</sup> As alluded to earlier, the main purpose of the separation is to 'ensure a balance of power and authority, such that no one individual has

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<sup>289</sup> Ibid.

<sup>290</sup> As noted earlier under heading 4.2 there are two key points concerning executive remuneration that numerous corporate governance codes recommend. Firstly, executive remuneration should be linked to performance and secondly individuals other than the executives should decide the levels of executive remuneration. In pursuant to the above, most corporate governance codes recommend that executive remuneration be decided by remuneration or compensation committee composed of majority independent directors.

<sup>291</sup> Lawrence, J and Stapledon, G, *Do Independent Directors add value*. Research Report, (1999), Centre for Corporate Law and Securities Regulation The University of Melbourne at 34.

<sup>292</sup> Ibid.

<sup>293</sup> Andrew Chambers, Insights from practice *A teddy bears' picnic or the lion's ring? Do non-executive directors add value?* Measuring Business Excellence (2005) Vol. 9 Issue 1 at 31.

<sup>294</sup> King II Paragraph 2.3.1.

unfettered powers of decision-making.<sup>295</sup> Furthermore it helps demonstrate independence of the role of the Chair.

Regarding the separation of the role between the CEO and the chairperson, some empirical evidence shows that, the separation does not result in improved corporate performance.<sup>296</sup> In contrast, a study on the first top 200 publicly traded Fortune 500 firms in the year 2000 showed that there was no harm when the CEO served as a regular director on the board.<sup>297</sup> Furthermore, the study also showed that in companies that do not practice a dual leadership structure, the CEO/chairperson are less likely to support the implementation of policies benefiting corporate management at the expense of stakeholders. Most importantly, the study showed that there is a negative impact on firm value when CEO also chairs the board.<sup>298</sup>

It is interesting to observe that, on the one hand, Enron Corporation practiced CEO duality, which may have been a factor, which contributed to the corporation's downfall. On the other hand, WorldCom and Global Crossing Ltd separated the positions of CEO and chairperson, but were still unable to control the corporation's wrong doings.<sup>299</sup>

#### **4.4.5 Other factors influencing corporate performance**

Other theoretical perspectives that support the premise that the independent director is important in guiding a company's performance include the agency theory, resource-dependence theory and the stakeholder theory. The agency

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<sup>295</sup> Ibid.

<sup>296</sup> Daily, C. and Dalton, D, 'The relationship between governance structure and corporate performance in entrepreneurial firms' *Journal of Business Venturing* (1992) Vol. 7 No. 5, pp. 375-86. Quoted in Steven T. Petra, *Do outside independent directors strengthen corporate boards?* *Corporate Governance* Vol. 5 No. 1 2005, 55-64 at 57.

<sup>297</sup> Chan, Kam C, Li, Joanne, *Audit Committee and Firm Value: Evidence on Outside Top Executives as Expert-Independent Directors*, *Corporate Governance: An International Review* (2008) Vol. 16 Issue 1, p16-31 at 22.

<sup>298</sup> Ibid

<sup>299</sup> Steven T. Petra, *Do outside independent directors strengthen corporate boards?* (2005) Vol. 5 No. 1 *Corporate Governance* 55 at 57.

theory suggests that a greater proportion of independent directors are better suited to monitor any self-interested actions by management. In turn, the high levels of monitoring should lead to improved corporate performance. However, the link between the agency theory and firm performance remains inconclusive. In support of the above, a case study on profit and non-profit organisations carried out in Australia 'failed to identify a positive relationship between a preponderance of outside directors and a reduction in agency costs.'<sup>300</sup>

From a stakeholder perspective, stakeholder orientations are likely to be more diversified amongst outside directors relative to inside directors.'<sup>301</sup> Wang and Dewhirst assert that,

Independent directors have a very strong stakeholder orientation, and recognize that their responsibility encompasses more than shareholders and are very conscious about the needs and expectations of the various constituencies of their firms.<sup>302</sup>

Through embarking on corporate social responsibility, independent directors assist in creating wealth in the community in which the corporation operates. Furthermore, outside directors also assist in managing a firm's various stakeholders.<sup>303</sup>

Regarding a company's share price, investors often see the presence of an independent director on company boards as an important element of good corporate governance, which may have the effect of raising the share price.

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<sup>300</sup> Gavin J. Nicholson and Geoffrey C. Kiel, *Can Directors Impact Performance? A case-based test of three theories of corporate governance*, (July 2007) Vol. 15 No 4 Journal of Political Economy 585 at 600.

<sup>301</sup> Carol-Anne Ho, S. Mitchell Williams, *International comparative analysis of the association between board structure and the efficiency of value added by a firm from its physical capital and intellectual capital resources*, (2003) Vol. 38 Issue 4 The International Journal of Accounting 465 at 473.

<sup>302</sup> Wang, J., & Dewhirst, H. D. (1992). *Boards of directors and stakeholder orientation*. Journal of Business Ethics 11(2), 115–121 at 120. Quoted in Carol-Anne Ho, S. Mitchell Williams, *International comparative analysis of the association between board structure and the efficiency of value added by a firm from its physical capital and intellectual capital resources*, (2003) Vol. 38 Issue 4 The International Journal of Accounting 465 at 473.

<sup>303</sup> Note 301 at 473. For instance in Germany, the supervisory board consists of 50 per cent employee representatives.

There is also strong evidence to indicate that investors are more willing to pay a premium for shares in a well-governed company.<sup>304</sup>

From the above studies, we note that the link between the independent director and firm performance remains inconclusive. Many authors are yet to reach consensus on whether the independent director contributes to the performance of the company. I am of the view that determining whether the independent director adds value to the corporation may continue to remain a challenge, as there are many factors that need to be taken into account to ascertain their value to the corporation. For instance, the environment in which the director operates, the size of the company and the duration for which the independent director has been on the board. However, I am of the view that independent director may add value through monitoring the company and ensuring compliance. In this regard, Chambers asserts that,

It is much safer ground to assert that non-executive directors add value in providing oversight of management with respect to the accountability, control and corporate governance aspects of best board practice.<sup>305</sup>

Above all, to be more valuable to the company, the independent director needs to overcome the challenges he experiences while carrying out his role. The next section of the dissertation discusses the challenges faced by the independent director before looking at means of making the independent director more effective.

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<sup>304</sup> Andrew Chambers, Insights from practice A teddy bears' picnic or the lion's ring? Do non-executive directors add value? (2005) Vol. 9 Issue 1 Measuring Business Excellence at 31.

<sup>305</sup> Ibid.



## 4.5 Challenges faced by the Independent Director

The independent director faces numerous challenges in carrying out his role in corporate governance. Some of these challenges relate to the environment in which the independent director operates and others relate to insufficient corporate governance mechanisms within companies that enable the independent director to act independently and efficiently.<sup>306</sup> Below is a discussion of some of the challenges faced by the independent director in fulfilling his role in corporate governance.

To begin with, some so called independent directors are not truly independent. At times, the independent director is often closely allied to management hence posing a challenge towards effective detached monitoring. For instance, an independent director may be a senior executive of another listed company, hence a fellow businessperson. As such, it is common for the director to socialise in the same circles or to serve as a fellow non-executive with the senior executives whom he is supposed to monitor.<sup>307</sup> This close interaction may present a barrier towards vigorous monitoring.<sup>308</sup>

Often an independent director develops close relations with executive directors, which is a positive thing as it usually leads to a high level of board cohesiveness. However, at times, high levels of cohesiveness are often accompanied by an absence of cognitive or task oriented disagreement. Van den Berghe and Baelden assert that, a high level of cohesiveness, accompanied by an absence of cognitive conflict can lead to groupthink.<sup>309</sup> Forbes and Milliken

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<sup>306</sup> For instance, board committees that are not composed according to the recommendations of corporate codes.

<sup>307</sup> G.P Stapledon *Institutional Shareholders and Corporate Governance*, (1996) at 144.

<sup>308</sup> For example, Stephen Koseff, CEO of Investec, sits on the board of Bidvest. Bidvest does a large amount of banking business with Investec, which raises the question whether Koseff is independent? For more information, please see, David Carte 'King 3's too soft'. Available at <http://www.moneyweb.co.za/mw/view/mw/en/page295050?oid=291608&sn=Detail&pid=174>. [Accessed 19 May 2009].

<sup>309</sup> Van den Berghe and Baelden, *The complex relation between director independence and board effectiveness*, Corporate Governance (2005) Vol. 5 No 5 at 64.

define groupthink as a 'dysfunctional mode of group decision making characterized by a reduction in independent thinking and a relentless striving for unanimity among members.'<sup>310</sup>

Furthermore, another factor, which may ally the independent director to management, is an excessively lengthy presence on the board of directors.<sup>311</sup> Over time, an independent director may become accustomed to some of the malpractices of the board and find it difficult to challenge such practices.<sup>312</sup> In addition, after a while there may be a change in qualities of the director. For instance, when the director was appointed, that individual possessed all the requisite qualities required by the company, but as time progressed, the director slackened and began to lose those qualities, they initially possessed.

Another challenge faced by the independent director relates to monitoring a board that is dominated by executives who have the bad behavioural characteristics or inadequate qualifications for their positions. For instance, if the boardroom atmosphere is filled with greed, arrogance or self-interest, operating in such an environment may be difficult.<sup>313</sup> Such an executive dominated board may make the boardroom culture or atmosphere unconducive to easy interaction between board members. For example, executive board dominance may be prevalent in companies where there is no separation between the chairperson and the CEO. Here, a CEO\chairperson with a domineering personality may use their personality to impose decisions on the board, thus hindering an opportunity for the independent director to contribute to board processes.

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<sup>310</sup> Forbes and Milliken, *Cognition and corporate governance: understanding boards as strategic decision-making groups*, Academy of Management, (1999) Vol. 24 No3 499-505 at 496. Quoted by Van den Berghe and Baelden, *The complex relation between director independence and board effectiveness*, *Corporate Governance* (2005) Vol. 5 No 5 at 64.

<sup>311</sup> G.P Stapledon, *Institutional Shareholders and Corporate Governance*, (1996) at 144.

<sup>312</sup> Overtime the directors may accustom to the 'scratch my back I scratch yours' syndrome in which a blind eye is turned to certain issues in return for favours. This may happen especially if independent directors sit as executives on the same board with non-executives who are executives of boards they also serve on.

<sup>313</sup> Some of these human nature conditions make the boardroom atmosphere difficult to work.

As the independent directorship is a part time function, limited time may be spent on board activity, which may result in affairs not being handled in depth. For example, a recent research showed that Dutch non-executive directors meet an average of 6.4 times a year.<sup>314</sup> Similarly in the USA non-executives 'expressed that the lack of time at board meetings, as well as the little time for preparation imposed a limit on their contributions.'<sup>315</sup>

In addition to time constraints, the independent director may lack detailed information on how the company is operating.<sup>316</sup> As such, the independent director has to rely on the information received from the executives in order to perform his duties. The fundamental challenge with the independent director relying on information from the executives is that, executives have control over the information they provide to the independent director. In other words, the executives are in a position to manipulate information in a manner that may influence the independent director to act in accordance with the executives' wishes.<sup>317</sup> The above problem may also be compounded for instance on a board that only has one executive director, as this could stifle the flow of information to the board.<sup>318</sup>

It is interesting to observe that, in order to monitor the executives, the independent director needs to be independent and unbiased. However, in order to do this, the independent director needs to rely on information he receives from the executives. In light of the above, monitoring, advising and acting

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<sup>314</sup> Reggy Hooghiemstra and Jaap van Manen, *The Independence Paradox: (im) possibilities facing non-executive directors in The Netherlands*, Corporate Governance: An International Review, (July 2004), Vol. 12 No.3 314 at 317.

<sup>315</sup> Ibid.

<sup>316</sup> Although the King II recommends that, the appointees to the board be persons with adequate knowledge about the company, this does not always happen. King II, paragraph 2.4.8.

<sup>317</sup> Reggy Hooghiemstra and Jaap van Manen, *The Independence Paradox: (im) possibilities facing non-executive directors in The Netherlands*, Corporate Governance: An International Review, (July 2004), Vol. 12 No.3 314 at 317.

<sup>318</sup> David Carte 'King 3's too soft'. Available at <http://www.moneyweb.co.za/mw/view/mw/en/page295050?oid=291608&sn=Detail&pid=174>. [Accessed 19 May 2009].

independently becomes difficult, as the executives may have tampered with the information they rely on.<sup>319</sup>

In addition to the limited time the independent director has to monitor the company, an independent director may lack the necessary experience to do his work effectively. This may lead the independent director into managing the company more conservatively as he fears exposing his inexperience.<sup>320</sup> Ritchie asserts that, 'individuals with the most valuable experience of company business are those who have worked for that company for many years, or who have been closely involved with it on a supply or demand level.'<sup>321</sup> Hence, 'those people especially in senior management positions are intimately aware of the company's position in the market, its processes and how to maximise its efficiency, where risks from competitors lie who are more likely to make better directors than individuals who begin with no experience of the company.'<sup>322</sup>

On a different note, the pool from which to choose independent directors is relatively small, even with the BEE requirements, which compel companies to employ a certain percentage of black employees in senior management and directorship positions. Currently, South African companies are constrained in their efforts to meet government-set targets as the pool from which to draw black skills either for directorships or other senior appointments is desperately small.<sup>323</sup>

Despite the numerous challenges that the independent director faces, there are means of enabling the independent director to be more effective. Below is a discussion on ways to make the independent director more effective.

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<sup>319</sup> Ibid.

<sup>320</sup> Thomas Ritchie, *Independent Directors: Magic Bullet or Band-Aid?* Corporate Governance eJournal. (2007) at 10. Available at <http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1004&context=cgej>

<sup>321</sup> Ibid.

<sup>322</sup> Ibid.

<sup>323</sup> Ethical Corporation *Inclusion A governance Catch-22*. Available at <http://www.ethicalcorp.com/content.asp?ContentID=6189&rss=70.xml> [Accessed 8 September 2009].

#### 4.6 Improving the effectiveness of the independent director

Firstly, for any director to be effective that director must possess three essential characteristics. That is to say, the director must possess an independent mind, the required level of competency and good behavioural characteristics.<sup>324</sup>

Good behavioural characteristics are integral towards influencing the effectiveness of the independent director. The reason being that, they directly relate to how individual directors work together to determine the manner in which company is managed to the interests of the shareholders.<sup>325</sup> Good behavioural characteristics may include honesty, right attitude and a high moral and ethical integrity.

Hence, it is important that companies appoint an independent director with good behavioural characteristics that fit within the individual behavioural characteristics of the existing board members.<sup>326</sup> In other words, the independent director should share a similar positive character with the current board members. In the same vein, the behavioural characteristics of the independent director should also fit within the strategy of the company. For example, if a company wishes to increase its stakeholder relations, such a company should aim to hire an independent director with,

Strong persuasive skills, a high degree of credibility and one who has the ability to work individually with a variety of people both inside and outside the company.<sup>327</sup>

Furthermore, companies should nominate an independent director who 'enjoys considerable influence among their peers and provides leadership their

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<sup>324</sup> R. Leblance and J. Cullies, *Inside the boardroom: how boards really work and the coming revolution in corporate governance* (2005) at 179.

<sup>325</sup> Ibid at 158.

<sup>326</sup> Ibid at 199.

<sup>327</sup> Ibid at 179.

peers can clearly endorse.<sup>328</sup> This is particularly important in the sensitive role the independent director often plays in advising and negotiating with the CEO and the board.<sup>329</sup> For example, an independent director who has the support of his peers can negotiate a remuneration package for the CEO that can easily be endorsed by the other board members.

Once the suitable individual who possess the good behavioural characteristics have been appointed as an independent director, it is imperative that he be provided with good incentives to enable him to be truly committed to performing his fiduciary duties.<sup>330</sup> Often, without appropriate incentives in place, few independent directors will actually invest the needed time and effort to learn and add value to the company.<sup>331</sup>

Therefore, as an incentive, an independent director could be compensated primarily with company stocks, not cash, for their services. This requires the independent director 'to buy a significant amount of company stocks using their own money at the time of joining the board as director.'<sup>332</sup> Furthermore, the independent director could be required to keep a significant proportion (for example, 60–80%) of his stock during his entire tenure as director and during the first one or two years after retirement from the board.<sup>333</sup> The above compels the independent director to become an owner of the company thus also providing an incentive for him to get involved in corporate governance of the company.<sup>334</sup>

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<sup>328</sup> D.A. Nadler, B.A. Behan, M.B. Nadler, *Building better boards: a blueprint for effective governance*, (2006) at 74.

<sup>329</sup> *Ibid.*

<sup>330</sup> Wei Shen, *Improve Board Effectiveness: the Need for Incentives*, *British Journal of Management*, (2005) Vol. 16, S81–S89 (2005) at S83.

<sup>331</sup> *Ibid.*

<sup>332</sup> *Ibid* at S86.

<sup>333</sup> *Ibid.*

<sup>334</sup> *Ibid.*

Additionally, it also assists in aligning the independent director's interests with those of the shareholders.<sup>335</sup>

'Due to the financial stakes involved, the independent director will also become more prudent in his decision to accept an invitation to join a company's board.'<sup>336</sup> Furthermore, 'the independent director will learn more about the company, and will seriously think about whether or not to take the responsibility of being its director.'<sup>337</sup> In acquiring the company stocks, it is also important that the independent director acquire a sizeable stake in the company, as this enables him to be motivated enough to question and challenge management proposals.

In order question and challenge executive management proposals, it is also imperative that, the independent director be in possession of the right information. Regarding the challenge of information asymmetry, the Higgs Report recommends that, the company secretary play a more central role towards the provision of information and supporting the effective performance of the independent directors.<sup>338</sup> Furthermore, the Higgs Report notes that, the independent director should be more responsible 'in judging the information he receives and provide feedback regarding the information received.'<sup>339</sup> In other words, the independent director should not hesitate to seek clarification where necessary regarding information received or required. The Higgs Report also recommends that, if the information received is not clear or appropriate this

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<sup>335</sup> However, as discussed earlier in the dissertation providing non-executives with share option incentives may lead them to concentrate on maintaining a high share price in order to reap in the benefits instead of operating the company as a going concern for the benefit of future shareholders. (Short termism). For example, the King III recommends that the non-executive directors take no part in share option schemes from the company on which they serve as directors.

<sup>336</sup> Wei Shen, *Improve Board Effectiveness: the Need for Incentives*, British Journal of Management, (2005) Vol. 16, S81–S89 (2005) at S87.

<sup>337</sup> Ibid at S87.

<sup>338</sup> Reggy Hooghiemstra and Jaap van Manen, *The Independence Paradox: (im) possibilities facing non-executive directors in The Netherlands*, Corporate Governance: An International Review, (July 2004), Vol. 12 No.3 314 at 323.

<sup>339</sup> Ibid.

should be signalled through the chairperson.<sup>340</sup> Having accesses to the right information enables the independent director to be kept abreast of the company's operational processes.

Upon receiving the right information, the independent director needs to be constantly engaged in the process of enlarging his understanding and perfecting his skills on how to operate the company.<sup>341</sup> To be more effective, the independent director should constantly know enough about the company's business and industry to enable him to determine which factors are critical to the business performance and which are not. An independent director who understands the company's business can make informed decisions on how the board should spend its limited time to determine better what information directors need when reviewing both corporate performance and strategy.<sup>342</sup> At the same time, constantly keeping himself abreast of the company's undertakings allows the independent director to avoid becoming stagnant on business issues.

The independent director should be ready to undertake educational activities to enhance his understanding of the company operations, in order to be abreast of the company's operations. Educational activities that the independent director may undertake include, 'a program of continuous stimulation by reading, in which new books or copies of interesting pamphlets are circulated to board members.'<sup>343</sup> Short courses and seminars on how to be a better board member may also be undertaken to improve the effectiveness of the director.

In summary, for the independent director to be more effective, it is necessary that companies appoint directors with the right characteristics that fit within the company objective and strategy. The independent director also needs

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<sup>340</sup> Ibid.

<sup>341</sup> Cyril O Houle, *Governing Boards: Their Nature and Nurture* (1989) at 51.

<sup>342</sup> D.A. Nadler, B.A. Behan, M.B. Nadler, *Building better boards: a blueprint for effective governance*, (2006) at 77.

<sup>343</sup> Cyril O Houle, *Governing Boards: Their Nature and Nurture* (1989) at 53.



to be given good incentives to encourage his involvement in corporate governance. For example, investing in the company's stock options, as this also facilitates the alignment of the independent director's interests with those of the shareholders. Access to the right information through the company secretary is also vital towards improving the effectiveness of the independent director. Furthermore, the ability to keep up to date with the company's operations and business environment through undertaking formal education is a necessity towards making the independent director more effective.

Having looked at ways to make the independent director more effective, the next part of the dissertation does a chapter-by-chapter summary before laying out the conclusion.

## SUMMARY

This dissertation sought to analyse the role of the independent director in maintaining good corporate governance. The analysis began with chapter one providing a brief overview of corporate governance. In this chapter, corporate governance was defined, amongst other things, as the system by which companies are directed and controlled.<sup>344</sup> In the overview, the dissertation also highlighted the main purpose of corporate governance as to protect the external providers of capital (the shareholders). It was highlighted that, adequate protection needs to be given to the shareholders to avoid those who run the company from abusing their power for their own personal benefit.

In the overview, the dissertation also touched on how the separation of ownership from control led to the agency problem. The dissertation noted that, due to the separation of ownership and control, executive directors are inclined to act in a self serving manner through only looking after their own interests' instead of those of the shareholders. In an attempt to overcome the agency problem, the dissertation suggested the appointment of independent directors to company boards. The above recommendation was based on the premise that, independent directors on the board could help align the interests of the executives with those of the shareholders and thus overcome the agency problem.

Chapter one concluded by looking at the rationale of the independent director in corporate governance. Some of the factors that were discussed include that, the independent director as a monitor assists in reducing conflicts of interest between the shareholders and the company management through bringing an independent voice to the boardroom. Above all, the underlying rationale of the independent director was that the independent director as an outsider is best suited to provide advice, monitor and protect the rights of

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<sup>344</sup> Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report), Paragraph. 2.5. Available at <http://www.ecgn.org.html> [Accessed 12 March 2009].

shareholders. The reason for this being that, since the independent director is not involved in the daily operations of the company he is able to give a detached view on how the company should operate in the best interests of the shareholders. In essence, the independent director is a better watchdog or monitor as compared to the executive director.

The next chapter discussed the board of directors and their role in corporate governance. Here, the dissertation discussed the composition of the board in line with the various corporate governance recommendations. Emanating from most of the corporate codes was the need to have more directors that are independent on company boards. This chapter also looked at other corporate governance recommendations such as splitting the role of the chairperson and that of the CEO. The dissertation noted that, it is imperative that the two roles be split to avoid an over concentration of power in one person which may lead to one individual possessing unfettered powers of decision-making.

The dissertation also touched on the statutory role of the board, which is to manage the business affairs of the company and perform any acts that are provided for in the Memorandum of Incorporation and the companies' legislation.<sup>345</sup> Other roles that were discussed include corporate decision-making, management and board selection and engaging in corporate social responsibility. In conclusion, chapter two looked at the duties of a director under South African law. Here, the dissertation briefly discussed the statutory and common law duties of a director. Most importantly, the chapter highlighted that in carrying out their duties, the law requires that the director serve the interests of the company to the exclusion of the interests of any such nominator, employer or principal.<sup>346</sup>

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<sup>345</sup> Section 66 (1) of the Companies Act No 71 of 2008.

<sup>346</sup> *Fisheries Development Corporation of SA Ltd v. Jorgensen* 1980 (4) SA 156 at 157.

Chapter three introduced the concept of an independent director. This chapter sought to define the independent director and ascertain if the law distinguishes between an executive director and the independent director or non-executive director. From the analysis, the dissertation revealed that in law there is no real distinction between the directors. Reference was made to the case of *Howard v Herrigel* in which the court noted that, 'it is unhelpful and even misleading to classify the company directors as executives or non-executives (Independent Director) for the purposes of ascertaining their duties to the company.'<sup>347</sup> Although no real distinction exists in law, the dissertation observed that a majority of corporate codes have distinct definitions for directors. To ascertain the above, a comparative analysis of how the various corporate codes define the independent director was undertaken. Emanating from most corporate codes was that, the independent director should be an individual who does not have any material ties with the company in which the directorship is held. Also observed was that, most codes in defining the independent director seem to omit soft factors such as the director's character and attitude, which are important in ascertaining if the person is truly independent.

The next task under chapter three was to look in depth at the role of the independent director in corporate governance. Here, the dissertation identified that the independent director has three primary roles, which are monitoring managerial activities, strategy development and communication and resolving conflicts. Of the three roles, the dissertation highlighted the monitoring role as the most important role of the independent director. The main reason for this being that, as an outside non-affiliated individual the independent director has the ability to analyse issues from a detached view, which in turn shows an unbiased perception of how the company is operating. In carrying out this monitoring role, the dissertation noted that, independent directors are effective as monitors when they ask tough questions to executives. The above essentially involves the

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<sup>347</sup> 1991 (2) SA 660 (A) at 661H.

independent director possessing the willingness and ability to question executives over decisions they make on behalf of the company. This point was highlighted in light of the fact that at times independent directors are appointed to serve certain interests outside the board. Nonetheless, in terms of South African law all directors are required to act in the best interests of the company as a whole.

In conclusion, chapter three looked at some of the external factors that influence and shape the role of the independent director. Some of the factors that were discussed include the amount of regulation within the industry and the presence of external stakeholders. The dissertation noted that a highly regulated corporate governance system might lead to over emphasis on the monitoring role played by independent director as the independent director tries to ensure that the company abides to the vast amount of regulations. Given the numerous regulations and the time the board meets during the year, this may pose a challenge towards effective monitoring.

Under chapter four, the dissertation analysed the independent director in action. This chapter dealt with how the independent director carries out his roles on the various board committees. Here, the dissertation discussed the independent director's roles on the audit, remuneration and nomination committees. Under the audit committee the dissertation highlighted the importance of the independent director's monitoring role in ensuring the accurate reporting of financial statements and minimising management earnings. The dissertation also highlighted the importance of the independent director in curbing excessive executive remuneration. Here the dissertation noted that, the independent director plays a vital role through recommending remuneration in a detached way from the executives. Furthermore, the dissertation noted that, the independent director lends credibility to the committee recommendations as the committee recommendations are made by independent individuals.

The next part of chapter four looked at whether the independent director adds value to the company. Here, an analysis of empirical studies carried out on the relationship between the independent director and firm performance was undertaken. An analysis on the relationship between the independent director and accurate financial reports showed that the results varied a lot. Some studies showed that, an audit committee composed of majority independent directors enhances auditor independence and effectiveness as an independent audit committee allows for extensive exploration of problems.<sup>348</sup> Other studies showed that, showed that the presence of independent directors on audit committees did not increase the reliability of financial information. Here, an example of the Enron audit committee was cited, which operated under the guidelines for independent audit committee, yet failed to observe the accounting discrepancies.

Still in chapter four, an analysis on the effect of an independent remuneration committee in Australia showed there was no evidence supporting the hypothesis that the relationship between corporate performance and CEO pay is stronger in companies with an independent remuneration committee compared to those with an insider-influenced remuneration committee.<sup>349</sup>

The varying results were explained in light of the numerous challenges that the independent director faces. The dissertation noted that, the challenges the independent director faces, such as the lack of independence and inadequate time to devote to the company, also play a part in deciding whether such a director adds value to the corporation. This part of chapter four observed, amongst other factors, that monitoring the executives may prove challenging on a board that is dominated by executives where there is no room for the independent directors to participate fully in board activities. Another challenge highlighted regarded the information received by the independent director. Here,

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<sup>348</sup> McMullen, Dorothy Ann *Audit Committee Performance: An Investigation of the Consequences Associated with Audit Committees*, Auditing: A journal of Practice and Theory, (1996) Vol. 15 No.1 at 88.

<sup>349</sup> Lawrence, J and Stapledon, G *Do Independent Directors add value*. Research Report, (1999), Centre for Corporate Law and Securities Regulation The University of Melbourne at 34.

the dissertation noted that the independent director relies heavily on information from the very same people whom he is supposed to monitor. As such, there is a possibility that executives may manipulate the information they provide to the independent director in an effort to foster their own personal interests.

In spite of the challenges cited above, chapter four concluded by looking at means of making the independent director more effective. Here, the dissertation recommended that, the independent director possess three qualities that may assist in fulfilling their roles. The qualities that were recommended were an independent mind, the required level of competency and good behavioural characteristics. Of the three noted above, the most important quality being good behavioural characteristics.

The dissertation also highlighted the need for good incentives to encourage the independent director to be more involved in the governance of the company. Incentives that were discussed include, providing the independent director with share options. In the same vein, the chapter highlighted the need for the independent director not to be pre occupied with maintaining a high share price while neglecting their obligation to create wealth for present and future shareholders and stakeholders.

Regarding the information asymmetry, chapter four concluded by noting the importance of the company secretary towards providing the independent director with accurate information. Furthermore, the independent director is also tasked with questioning the veracity of the information received before acting upon it. In the same vein, the independent director was encouraged to undertake further education to sharpen his mental skills and keep up to date with the growing business and economic trends in society.

## **CHAPTER 5: CONCLUSION**

The underlying theme of my study was to analyse the role of the independent director in maintaining corporate governance. The analysis was undertaken in light of a number of corporate governance recommendations, which advocate for the independent director to take a more central role within corporate governance.

The separation of ownership from control, which led to the agency problem, saw the introduction of the independent director as a means of monitoring managerial activities and ensuring that the executive management carries on business in the best interests of the shareholders. This dissertation revealed the monitoring of managerial activities as one of the most important functions of the independent director. In carrying out this monitoring role, the dissertation highlighted how important it is for the independent director to be probative towards the executive management regarding decisions made on behalf of the company. Few may argue against the fact that the objective, transparent monitoring of company affairs by an outsider is essential towards maintaining good corporate governance standards.

The dissertation also revealed the importance of the monitoring role played by the independent director in ensuring the accurate presentation of financial data and curbing executive pay. Although some of the results regarding the effectiveness of the independent director's monitoring role varied, there was some strong evidence that independent directors could minimise incidences of management earnings and curb executive remuneration.

However, in carrying out the monitoring role, the dissertation revealed that the independent director does face numerous challenges that hinder the director's effectiveness. For instance, challenges of information asymmetry, monitoring an executive dominated board and limited time designated for board activities. Nonetheless, this dissertation showed the value that the independent director brings through the monitoring role in corporate governance.



From this analysis, I would recommend the need for more research to be undertaken to ascertain more clearly the role of the independent director in corporate governance. This may be done through companies allowing researchers access to their premises to research the role and effect of the independent director on company boards. Emanating from the research, corporate codes may be used to set out clearly the role of the independent director. Future research may also need to be undertaken on means to overcome the challenges faced by the independent director as these challenges influence the role and effectiveness of the independent director.

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